Supreme Court, U.S.
FILED

03 171 JUL 29 2003

OFFICE OF THE CLERK

No. 03-

IN THE

Supreme Court of the United States

STERLING HOLDING COMPANY, LLC, and
NATIONAL SEMICONDUCTOR CORPORATION,

Petitioners,

v.

MARK LEVY,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

PAUL VIZCARRONDO, JR.
MICHAEL A. CHARISH
WACHTELL, LIPTON,
ROSEN & KATZ
51 West 52nd Street
New York, NY 10019
(212) 403-1000

*Counsel for Petitioner
National Semiconductor
Corporation*

STEVEN B. FEIRSON
Counsel of Record
FRANCES S. COHEN
GEORGE M. GOWEN III
DECHERT LLP
4000 Bell Atlantic Tower
1717 Arch Street
Philadelphia, PA 19103
(215) 994-4000

*Counsel for Petitioner
Sterling Holding Company, LLC*

181989

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

126 pp

QUESTION PRESENTED

Whether the court of appeals was required to follow the plain language of Securities and Exchange Commission ("Commission") Rules 16b-3 and 16b-7, or at least defer to the Commission's interpretation of those rules, rather than issuing a ruling that, in the words of the Commission itself, "misconstrued the Commission's intent, and . . . frustrated the Commission's purpose in adopting the rules."

CORPORATE DISCLOSURE STATEMENT PURSUANT TO SUPREME COURT RULE 29.6

Petitioner Sterling Holding Company, LLC is owned by Citicorp Venture Capital Ltd., which is a wholly-owned subsidiary of Citibank N.A., which is a wholly-owned subsidiary of Citicorp, which is a wholly-owned subsidiary of Citigroup Holdings Company, which is a wholly-owned subsidiary of Citigroup Inc. Of these parent corporations, Citigroup Inc. is the only publicly held company.

Petitioner National Semiconductor Corporation is a publicly traded company. There are no publicly traded companies that own 10% or more of National Semiconductor Corporation's stock.

TABLE OF CONTENTS

	Page
Question Presented	i
Corporate Disclosure Statement Pursuant to Supreme Court Rule 29.6	ii
Table of Contents	iii
Table of Cited Authorities	vi
Table of Appendices	ix
Opinions Below	1
Jurisdiction	1
Statutory and Regulatory Provisions Involved	1
Statement of the Case	1
A. The Fairchild Reclassification	3
B. The Complaint	5
C. Section 16(b) and the SEC Rules	5
1. Exemption under Rule 16b-3(d)	5
2. Exemption under Rule 16b-7	6
D. The Motion to Dismiss in the District Court	7
E. Reversal in the Court of Appeals	8

Contents

Page

F. The Petition for Rehearing and the Commission's Position 9

G. The Denial of the Petition for Rehearing ... 10

Reasons for Granting the Petition 11

A. Summary of Reasons 11

1. The decision below directly conflicts with clear Supreme Court precedent. .. 11

2. The decision below creates a conflict in the circuits. 12

3. The decision below threatens to disrupt the routine functioning of the markets and business. 12

B. The Court of Appeals Decision Directly Conflicts with the Decisions of this Court that Require Controlling Weight to Be Given to the Commission's Rules and Its Interpretation of Those Rules. 13

1. Rule 16b-3(d) 15

a. The court of appeals' compensatory purpose requirement appears nowhere in the rule. 15

Contents

Page

b. Rule 16b-3's adopting release explicitly forecloses the court of appeals' newly-created compensatory purpose requirement. 16

c. In this case, the Commission labeled the court of appeals' judicially crafted revision of Rule 16b-3(d) as being "directly contrary" to the reasons underlying the exemption. 16

2. Rule 16b-7 19

a. The rule and the Commission's interpretative releases leave no doubt that the reclassification is exempt. 19

b. The Commission's no-action letters make clear that the Fairchild reclassification is exempt. 20

c. In this case, the Commission flatly rejected the court of appeals' re-writing of Rule 16b-7. 22

C. The Decision Below Creates a Conflict Between the Second and Third Circuits. ... 26

D. The Issues Presented by the Conflicts Are Recurring and of Great Practical Importance. 27

Conclusion 29

TABLE OF CITED AUTHORITIES

Page

Cases:

Auer v. Robbins, 519 U.S. 452 (1997) 14, 26 n.12

Bowles v. Seminole Rock & Sand Co, 325 U.S. 410 (1945) 14, 26

Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984) 8, 13, 14, 15, 25

Gryl v. Shire Pharmaceuticals Group PLC, 298 F.2d 136 (2d Cir. 2002) 12, 26, 27

Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973) 1, 2

Levy v. Southbrook Int'l Invs., Ltd., 263 F.3d 10 (2d Cir. 2001) 25 n.12, 26 n.12

Skidmore v. Swift & Co., 323 U.S. 134 (1944) ... 21 n.11

TVA v. Hill, 437 U.S. 153 (1978) 15

United States v. Mead Corp., 533 U.S. 218 (2001) .. 13

United States v. Morton, 467 U.S. 822 (1984) 13

Statutes:

Del. Code § 242(b)(1) 6

5 U.S.C. § 706(2)(A), (D) 13

15 U.S.C. § 78aa 5

15 U.S.C. § 78p(b) ..... *passim*

Cited Authorities

Page

Rule:

Fed. R. Civ. P. 12(b)(6) 7

Regulations:

17 C.F.R. § 240.16a-10 14

17 C.F.R. §§ 240.16b-1 - 240.16b-8 14

17 C.F.R. § 240.16b-3 ..... *passim*

17 C.F.R § 240.16b-7 ..... *passim*

Other Authorities:

Adoption of Rule X-166-7, Exchange Act Release No. 34-4,717, 1952 WL 7278 (June 9, 1952) 19

Certain Acquisition and Dispositions of Securities Pursuant to Mergers and Consolidations, Exchange Act Release No. 34-4,696, 1952 SEC LEXIS 63 (Apr. 1952) 19

Monk Austin, Inc., SEC No-Action Letter, 1992 Fed. Sec. L. Rep. (CCH) ¶ 76,296, 1992 WL 337451 (Nov. 19, 1992) 7, 20, 21

Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, Exchange Act Release No. 34-28,869, 1991 WL 292000 (Feb. 21, 1991) 19

Cited Authorities

Page

Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, Exchange Act Release No. 34-37,260, 1996 WL 290234 (May 31, 1996) 9, 16, 17, 18

Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 34-18,114, 1981 WL 31301 (Sept. 24, 1981) 19

St. Charles Acquisition Ltd. Partnership, SEC No-Action Letter, 1992 Fed. Sec. L. Rep. (CCH) ¶ 76,223, 1992 WL 146565 (June 25, 1992) 21

TABLE OF APPENDICES

Page

Appendix A — Opinion Of The United States Court Of Appeals For The Third Circuit Filed December 19, 2002 ..... 1a

Appendix B — Memorandum And Order Of The United States District Court For The District Of Delaware Dated And Filed February 5, 2002 ... 43a

Appendix C — Order Of The United States Court Of Appeals For The Third Circuit Denying Petition For Rehearing Dated April 30, 2003 ..... 53a

Appendix D — Statutes and Regulations Involved .. 55a

Appendix E — Order Of The United States Court Of Appeals For The Third Circuit Dated March 31, 2003 ..... 62a

Appendix F — Motion For Leave To File Memorandum, And Memorandum Of The Securities And Exchange Commission, *Amicus Curiae*, In Support Of Appellees' Petition For Rehearing And Rehearing *En Banc* Dated February 27, 2003 ..... 64a

Appendix G — Opinion Of The United States Court Of Appeals For The Third Circuit Dated March 17, 2003 ..... 82a

OPINIONS BELOW

The opinion of the court of appeals, (App. at 1a-42a),[1] is reported at 314 F.3d 106. The opinion of the district court is reported at 2002 WL 187513.

JURISDICTION

The court of appeals issued its decision on December 19, 2002 and denied a timely petition for rehearing on April 30, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

This case involves section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (2000). This case also involves two rules promulgated thereunder by the Commission: Rules 16b-3 and 16b-7, 17 C.F.R. §§ 240.16b-3(d) (1996), 240.16b-7 (1991). These provisions are lengthy and are set forth verbatim in the attached Appendix. (App. at 55a-61a.)

STATEMENT OF THE CASE

The purpose of section 16(b) is to prevent an insider from trading on non-public information to earn a speculative profit at the expense of uninformed market participants. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 591-92 & n.23 (1973). The statute does not mandate an inquiry into whether such unfair use has actually occurred. Rather, the statute imposes an automatic rule of liability on short-swing transactions — those where there is a purchase and a sale by an insider within a six month period.

---

1. References herein such as "(App. at __)" are to the Appendix to this petition.

Because of its "crude," arbitrary, and "strict" terms, *Kern County*, 411 U.S. at 592 n.23 & 595, Congress recognized that section 16(b) would sweep too broadly if applied without exception. Hence, Congress expressly authorized the Commission to exclude from the scope of section 16(b) "any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." 15 U.S.C. § 78p(b). Thus, Congress expressly directed the Commission to fill the "gaps" left by its enactment, i.e., to formulate such exemptions as the Commission, in its expert judgment, deemed necessary to avoid bringing within the broad ambit of section 16(b) those transactions that had no real risk of speculative abuse.

In this case, in an attempt to create liability under section 16(b), Plaintiff Mark Levy portrayed a routine corporate reclassification of stock, undertaken to facilitate an initial public offering ("IPO"), as a "purchase" of securities. Plaintiff made this claim despite the fact that pre-IPO, internal changes in capital structure do not implicate any inside information, do not impact any market participant, and are fully disclosed to the market in connection with the IPO. Perhaps not surprisingly, this unremarkable, non-public transaction was, prior to the decision below, widely thought to be exempt from liability pursuant to two separate Commission rules – Rules 16b-3 and 16b-7. Rule 16b-3(d) exempts insider acquisitions of issuer stock that are approved by a majority of shareholders or the board of directors. Rule 16b-7 exempts reclassifications that are the substantive equivalent of mergers or consolidations between companies with at least 85% cross-ownership.

Relying on these exemptive rules, Petitioners Sterling Holding Company, LLC ("Sterling") and National Semiconductor Corporation ("National" and, with Sterling, "Defendants") filed a motion to dismiss the Complaint. The district court granted that motion. On appeal, the United States Court of Appeals for the Third Circuit reversed.

Defendants filed a timely petition for rehearing. The Commission, stating that transactions such as the one here have no significant risk of speculative abuse, filed a brief *amicus curiae* supporting the petition for rehearing. The Commission's brief further made clear that the ruling of the court of appeals ignored both the language of the exemptive rules and the Commission's interpretation of those rules. As a result, in the Commission's view, the decision of the court of appeals "misconstrued the Commission's intent, and . . . frustrated the Commission's purpose in adopting the rules." (App. at 68a.)[2] The court of appeals nevertheless, on a split vote, refused to grant the petition for rehearing.

A. The Fairchild Reclassification[3]

Before 1997, Fairchild Semiconductor International, Inc. ("Fairchild"), was a subsidiary of National. (*See* A120.)[4] In March 1997, pursuant to an agreement among National, Fairchild, and Sterling, National spun off Fairchild into a separate corporate entity. (*Id.*)

At that time, Sterling and National each acquired shares of the three classes of stock in the newly-created Fairchild: (1) Class A Common Stock; (2) Class B Common Stock; and (3) Series A Preferred Stock. (A24; A177; A180-83.) The Series A Preferred Stock was issued with a pre-determined liquidation value of $1,000 per share. (A24-A25.) Sterling purchased 53,113 shares of Series A Preferred Stock, approximately 3,553,000

---

2. The Commission's motion for leave to submit its brief and the brief itself are reproduced in the Appendix to this petition. (App. at 64a-81a.)

3. The recitation of the facts set forth herein is taken from the Complaint.

4. References herein such as "(Axx)" are to the specified pages of the Joint Appendix submitted to the court of appeals. Petitioners would be pleased to provide additional copies to this Court if requested.

shares of Class A Common Stock, and 7,099,000 shares of Class B Common Stock. (A24-A25.) National acquired 11,667 shares of Series A Preferred Stock, 4,380,000 shares of Class A Common Stock, and 5,243,621 shares of Class B Common Stock. (A24-A25.)

At all times relevant to this action, Sterling and National each beneficially owned more than 10% of Fairchild's outstanding common stock. In addition, each had the power to designate certain members of Fairchild's board of directors. (A2, A21-22.)

On July 1, 1999, more than two years following Sterling's and National's initial investments, a majority of shareholders voted to amend Fairchild's charter to reclassify all outstanding shares of the Series A Preferred Stock into shares of Class A Common Stock. (A24-A25.) The charter amendment provided a pre-determined formula for the reclassification, which was to take place simultaneously with Fairchild's IPO. Fairchild fully and accurately disclosed the reclassification in the IPO offering prospectus, which was an exhibit to Fairchild's Form S-1 filed with the Commission on July 9, 1999. (A24-A25.)

The reclassification took place in conjunction with the IPO on August 9, 1999. (A25.) Each and every outstanding share of Series A Preferred Stock was automatically and mechanically converted into Class A Common Stock according to the predetermined conversion formula: the $1,000 liquidation value, plus accumulated and unpaid dividends, was divided by $17.39, the price Fairchild received for each share of Class A Common Stock sold in the IPO. (A25-A26.) No action on the part of the shareholders was required for the reclassification to take effect. As a result of the reclassification, Sterling's 53,113 shares of Preferred Stock were converted into 4,021,428 shares of Class A Common Stock. (A25-A26.) National's 11,677 shares of Preferred Stock were converted into 883,362 shares of Class A Common Stock. (A25-A26.)

On January 19, 2000, nearly three years after the March 1997 spin-off that marked National and Sterling's initial investments, but just less than six months after the reclassification, Fairchild made a secondary offering of its Class A Common Stock in which Sterling sold 11,115,000 shares and National sold 7,243,360 shares. (A26.)

B. The Complaint

Plaintiff alleges he is a Fairchild shareholder and brought this action purportedly on behalf of Fairchild. (A19.) In his Complaint, Plaintiff contended that the pre-IPO reclassification constituted a new "purchase" of stock within the meaning of section 16(b). Hence, Plaintiff argued that, for purposes of matching a section 16(b) "purchase" with the January 19, 2000 "sale," Defendants "purchased" shares when their Series A Preferred Stock was reclassified into Class A Common Stock on August 9, 1999, even though they made no new investment in Fairchild at that time. (A26.) On that basis, Plaintiff sought, pursuant to section 16(b), "disgorgement" of the profits from the sale of stock by Defendants on January 19, 2000. Federal jurisdiction was based on 15 U.S.C. § 78aa. (A20.)

C. Section 16(b) and the SEC Rules

The Commission has promulgated rules specifically exempting certain classes of transactions from section 16(b) liability. Defendants argued that at least two of those exemptions apply in this case.

1. Exemption under Rule 16b-3(d)

Rule 16b-3(d) exempts the acquisition of securities by a director from the issuer, provided that one of three alternative conditions is met: (1) the transaction is approved by the issuer's board of directors, (2) the transaction is approved by a majority of the issuer's shareholders entitled to vote, or (3) the director

holds the securities for at least six months. *See* 17 C.F.R. § 240.16b-3(d).

In this case, Plaintiff alleged in his Complaint: (1) that Sterling and National were "directors by deputization" of Fairchild because they designated individuals to serve on Fairchild's board; (2) that Sterling and National acquired Class A Common Stock directly from Fairchild in a reclassification; and (3) that the reclassification was approved in early July 1999 by a majority of Fairchild's shareholders.[5] Thus, the Complaint itself alleges each of the elements required by the plain language of Rule 16b-3. (A21-22, A24-26.)[6]

2. Exemption under Rule 16b-7

Rule 16b-7 provides an exemption from section 16(b) liability for reclassifications. As originally promulgated, Rule 16b-7 created an exemption for merger or consolidation transactions between companies with 85% "cross-ownership," *i.e.*, those in which one of the companies already owned 85% or more of the other. In a 1981 interpretive release, the Commission explained that the rule could apply, as well, to transactions that are the substantive equivalent of the exempted merger and consolidation transactions. The release specifically identified reclassifications as among the classes of transaction covered by the exemption. Thereafter, in 1991, the Commission amended Rule 16b-7 to add "Reclassifications" to the title of the rule.[7] The Complaint

---

5. Plaintiff also implicity alleged that the reclassification was approved by Fairchild's board of directors by alleging that it was accomplished through an amendment to Fairchild's certificate of incorporation, which, under Delaware law, requires board approval. *See* Del. Code § 242(b)(1) (1999) (requiring board resolution for amendment to certificate of incorporation).

6. The full text of Rule 16b-3(d) is reproduced in the Appendix to this petition. (App. at 57a-58a.)

7. The full text of Rule 16b-7 is reproduced in the Appendix to this petition. (App. at 59a-61a.)

alleges that the transaction at issue here is a reclassification. (A21.)

D. The Motion to Dismiss in the District Court

Sterling and National moved to dismiss the Complaint pursuant to Fed. R. Civ. P. 12(b)(6) on the ground that Fairchild's reclassification was exempt under Rules 16b-3(d) and 16b-7. In opposition, Plaintiff argued that neither Rule 16b-7 nor Rule 16b-3 applied to the transaction alleged in the Complaint. Plaintiff did not seek discovery or allege that any issues of fact were in dispute. Indeed, a joint status report, filed by all parties, stated that "[t]his case presents two threshold questions of law that independently are potentially dispositive of the case," *i.e.*, the applicability of the Rule 16b-3 and Rule 16b-7 exemptions. (A68.) The status report represented that, "[i]n connection with the pending motions to dismiss, there are no material disputes of fact." (A70.)

On February 5, 2002, the district court issued a memorandum and order granting Defendants' motions and dismissing the Complaint with prejudice on the ground that the reclassification was exempt under the plain language of Rule 16b-7: "In particular, the SEC has exempted 'mergers, reclassifications, and consolidations' via SEC Rule 16b-7." *Levy v. Sterling Holding Co., LLC*, No. Civ.A.00-994, 2002 WL 187513, at *3 (D. Del. Feb. 5, 2002).

In addition to the language of the rule, the district court relied on the fact that, "in light of the SEC's own interpretation of its rules and regulations, it seems clear the provisions of Rule 16b-7 apply to reclassifications." 2002 WL 187513, at *3. The district court also pointed to an SEC no-action letter, involving a similar transaction, as a basis for holding that the reclassification was not a purchase within the meaning of Rule 16b-7. *Id.* at *3-4 (citing *Monk-Austin, Inc.*, SEC No-Action Letter, 1992 Fed. Sec. L. Rep. (CCH) ¶ 76,296, 1992 WL 337451 (Nov. 19, 1992)).

In summary, the district court found that the transaction was exempt and dismissed the Complaint:

> On balance, the court finds that all relevant factors indicate that the transaction here was a reclassification of stock in anticipation of an IPO, rather than a purchase. The SEC has repeatedly interpreted its regulations as exempting reclassifications from the scope of Section 16(b).

Id. at *4. Because the district court found that Rule 16b-7 applied to the transaction, it did not reach the applicability of the Rule 16b-3(d) exemption. *Id.*

E. Reversal in the Court of Appeals

The court of appeals reversed. *Levy v. Sterling Holding Co., LLC*, 314 F.3d 106, 125 (3d Cir. 2000). The court acknowledged that Congress provided in section 16(b) that "the SEC may exempt certain transactions from the coverage of the statute." *Id.* at 111. And the court noted its obligation under the law of this Court: "courts defer to an agency's interpretations of statutes, particularly where the statute provides the agency with authority to make the interpretation." *Id.* at 112 (citing *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984)). Nonetheless, citing to what it believed to be "an absence of specific SEC guidance," the court of appeals proceeded to give its own interpretation of Rules 16b-3 and 16b-7.

As to Rule 16b-3, the court of appeals announced a requirement that appears nowhere in the rule. In particular, the court held that, to qualify for exemption under Rule 16b-3(d), the transaction at issue must "have some connection to a compensation-related function." 314 F.3d at 124. The court reached this conclusion notwithstanding the fact that the Commission in its adopting release had stated that a transaction

"need not be pursuant to . . . any compensatory program to be exempt, nor need it specifically have a compensatory element." *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Exchange Act Release No. 34-37,260, 1996 WL 290234, at *6 (May 31, 1996) (the "1996 Adopting Release").

The court of appeals also provided its own interpretive gloss with respect to Rule 16b-7. The court held that Rule 16b-7 does not apply to reclassifications where: (1) the reclassification increased the defendants' proportionate ownership of common stock, 314 F.3d at 117; or (2) where the reclassification changes the risks and opportunities of the preferred shareholders, *id.* at 117-18. The court of appeals remanded the case to the district court for further factual inquiry into whether the "reclassification transaction had the potential for speculative abuse." *Id.* at 119.

F. The Petition for Rehearing and the Commission's Position

Thereafter, Defendants petitioned for rehearing. In connection with that petition, the Commission, "the agency responsible for the administration and enforcement of the federal securities laws," filed a memorandum supporting the grant of rehearing. (App. at 64a.) The Commission further requested that, in the event the court of appeals granted rehearing, the court permit the Commission to file a brief "explaining its position in full." (App. at 66a.)

The Commission urged rehearing because, *inter alia*:

> In holding that the transactions here were not exempt under the rules, the [Third Circuit] viewed the rules as ambiguous and therefore applied its view of how the Commission would apply the rules to these transactions.

(App. at 65a.) The Commission stated that it was intervening because the court of appeals decision "misconstrued the Commission's intent, and thereby frustrated its purpose, in adopting the rules." (App. at 65a.) The Commission viewed the panel decision as "seriously incorrect" and the "need for Commission participation" as patent. (App. at 86a.)[8]

The Commission explained that it had not intervened prior to the court of appeals' decision because:

> The Commission does not routinely participate as *amicus curiae* where a district court has ruled correctly and the prospect for reversal on appeal appears to be low. The district court's decision in this case is fully consonant with the Commission's position in this case, and the staff would not have anticipated that the [court of appeals] would rule otherwise.

(App. at 86a.)

G. The Denial of the Petition for Rehearing

Despite having now received the "specific SEC guidance" it previously said it lacked, and despite the Commission's request for rehearing to explore more fully the issues raised by the court of appeals' decision, the court denied the Petition for Rehearing in a summary order. (App. at 53a-54a.) One member of the panel voted for panel rehearing, and three active judges of the Third Circuit, including Chief Judge Becker, voted to rehear the case *en banc*. (App. at 54a.)

---

8. In response to an order of the court of appeals, the Commission also filed a supplemental memorandum explaining when it became aware of the litigation, which is reproduced in the Appendix to this petition. (App. at 82a-86a.)

REASONS FOR GRANTING THE PETITION

A. Summary of Reasons

1. The decision below directly conflicts with clear Supreme Court precedent.

The decision below directly conflicts with Supreme Court precedent as to a vitally important and frequently recurring issue of federal law: when a court must give controlling weight to the duly promulgated rules of a federal agency and to the agency's interpretation of its own rules. This issue lies at the heart of every federal regulatory scheme where an agency is charged by Congress with the promulgation of rules and the administration of a regulatory program.

In a situation in which Congress expressly charged the Commission with promulgating exemptions from section 16(b) liability, the court of appeals has interpreted Rules 16b-3(d) and 16b-7 in a fashion that: (1) departs from the plain meaning of the words of the rules; (2) ignores the Commission's interpretive releases; (3) fails to give appropriate consideration to the Commission's guidance in no-action letters; and (4) directly conflicts with the position the agency has taken in this case that the specific transaction at issue is exempt. Instead, the court substituted its own judgment about what the exemptions should and do mean. In so doing, the court of appeals acted in conflict with the decisions of this Court that require an agency's rules, and the agency's interpretation of its own rules, to be given controlling weight. This conflict has now raised new questions that threaten to obscure the clear rules, laid down by this Court over the past seventy years, concerning the proper roles of administrative agencies and federal courts in the functioning of regulatory schemes. *See infra* pp. 13-26.

2. The decision below creates a conflict in the circuits.

The court of appeals' reinterpretation of Rule 16b-3(d) creates one current direct conflict among the circuits and potentially numerous others. While the court of appeals attempted to distinguish the decision of the United States Court of Appeals for the Second Circuit in *Gryl v. Shire Pharmaceuticals Group PLC*, 298 F.2d 136 (2d Cir. 2002), the decision in that case remains in direct and stark conflict with the decision in this case. As it currently stands, in the Third Circuit a defendant must show that a transaction had a compensatory purpose in order to come within Rule 16b-3(d)(1), while in the Second Circuit a defendant need not make such a showing. Not only does that split create different "federal law" by virtue of geography, but the importance of the underlying question will make forum selection vital to litigants. Defendants in the Second Circuit will be held to a different standard than defendants in the Third Circuit, and those operating in both circuits will suffer a state of uncertainty as to the legal ramifications of their actions.

This state of affairs is especially troubling given that Delaware, the state of incorporation for much of corporate America, is located in the Third Circuit. Hence, venue will be easily available in Delaware for those who seek to forum shop. Permitting the decision below to stand will both heighten the incentive to forum shop and create a barrier to a nationally uniform interpretation of the securities laws. *See infra* pp. 26-27.

3. The decision below threatens to disrupt the routine functioning of the markets and business.

If permitted to stand, the decision of the court of appeals will engender confusion among those in the market about when, and in what circumstances, section 16(b) liability will attach. That confusion is particularly disturbing in situations like this

one. Plaintiffs are focusing, not on a single transaction by a single individual, but rather on broad classes of transactions where there is no trading into a public market. In such transactions, participants previously thought they were merely engaging in routine reclassifications of shares necessary to implement changes in the capital structure of a company. The sort of uncertainty that the decision of the court of appeals creates will likely adversely affect those who contemplate such transactions. Moreover, the perceived inability to rely upon the rules and pronouncements of the Commission may have consequences far beyond the section 16(b) context. Every day, the securities markets and market participants count on the predictability created by the regulatory efforts of the Commission. The decision of the court of appeals serves to undermine that predictability. *See infra* pp. 27-29.

B. The Court of Appeals Decision Directly Conflicts with the Decisions of this Court that Require Controlling Weight to Be Given to the Commission's Rules and Its Interpretation of Those Rules.

Given the repeated directions from this Court, there now should be little doubt that an agency's rules, adopted pursuant to express congressional authorization, and an agency's interpretation of its own rules, are entitled to controlling weight in the courts. As this Court has held repeatedly, "[w]hen Congress has 'explicitly left a gap for an agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation,' . . . and any ensuing regulation is binding on the courts unless procedurally defective, arbitrary or capricious in substance." *United States v. Mead Corp.*, 533 U.S. 218, 219 (2001) (quoting *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984), and citing *United States v. Morton*, 467 U.S. 822, 834 (1984), and the Administrative Procedure Act, 5 U.S.C. § 706(2)(A), (D)).

The language of section 16(b) makes clear that it is a statute in which Congress has "explicitly left a gap" and directed the Commission to fill it. 15 U.S.C. § 78p(b). And the Commission has, in fact, followed the direction of Congress. Through a formal rule-making process, including notice and comment, the Commission has promulgated rules exempting several kinds of transactions from section 16(b). *See* 17 C.F.R. §§ 240.16b-1 - 240.16b-8 (2001); *see also* 17 C.F.R. § 240.16a-10 (2001). These exemptions employ objective criteria to define classes of transactions that the Commission has determined are not likely to present significant opportunities for abuse. Like the liability provisions of the statute, these exemptive rules provide certainty to those involved in business transactions and relieve courts of the burden of having to make fact-specific, case-by-case judgments regarding motive and the actual or potential abuse of inside information. Because Congress expressly authorized the Commission to make these rules and regulations, they are "binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute." *Mead*, 533 U.S. at 219; *accord Chevron*, 467 U.S. at 843-44.

Moreover, as this Court held in *Bowles v. Seminole Rock and Sand Co.*, 325 U.S. 410, 417 (1945), "[a]ny doubts concerning this interpretation of the [rules] . . . are removed by reference to the administrative construction. . . ." Because the exemptions set forth in Rules 16b-3(d) and 16b-7 are "creature[s]" of the Commission's "own making," the Commission's "interpretation of [them] is, under our jurisprudence, controlling unless 'plainly erroneous or inconsistent with the regulation.'" *Auer v. Robbins*, 519 U.S. 452, 461 (1997) (quoting *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945)).

The reason for this carefully crafted structure is straightforward:

> When a challenge to an agency construction of a statutory provision, fairly conceptualized, really

> centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail. In such a case, federal judges – who have no constituency – have a duty to respect legitimate policy choices made by those who do. The responsibilities for assessing the wisdom of such policy choices and resolving the struggle between competing views of the public interest are not judicial ones: "Our Constitution vests such responsibilities in the political branches."

Chevron, 467 U.S. at 865 (quoting *TVA v. Hill*, 437 U.S. 153, 195 (1978)).

Here, the Commission has exercised the power expressly delegated to it by Congress to create exemptions to section 16(b) liability. Those exemptions, and the Commission's interpretation of those exemptions, embody the expertise of the agency. And it is precisely that expertise that the court of appeals rejected.

1. Rule 16b-3(d)

a. The court of appeals' compensatory purpose requirement appears nowhere in the rule.

The compensatory purpose requirement imposed by the court of appeals does not appear anywhere in Rule 16b-3(d). Rather, the rule provides that "***[a]ny*** transaction involving a grant, award or other acquisition from the issuer . . . shall be exempt if," *inter alia*, it is approved by the issuer's board of directors or the majority of its voting-eligible stockholders. 17 C.F.R. 240.16b-3(d) (emphasis added). The court of appeals unilaterally added the compensatory purpose nexus requirement and thereby rewrote the facial meaning of the rule.

b. Rule 16b-3's adopting release explicitly forecloses the court of appeals' newly-created compensatory purpose requirement.

In a release accompanying its adoption of Rule 16b-3, the Commission explained that, contrary to the position adopted by the court of appeals in this case, eligibility for the exemption did not depend on whether a transaction was compensatory in nature. Rather, noted the Commission, unlike the old Rule 16b-3 which did require some sort of compensatory nexus:

> New Rule 16b-3 exempts from short-swing profit recovery ***any*** acquisitions and dispositions of issuer equity securities . . . between an officer or director and the issuer, subject to simplified conditions. . . . ***[U]nlike the current rule, a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element.***

1996 Adopting Release, 1996 WL 290234, at *6 (emphasis added).

c. In this case, the Commission labeled the court of appeals' judicially crafted revision of Rule 16b-3(d) as being "directly contrary" to the reasons underlying the exemption.

In its *amicus* brief submitted to the court of appeals in this case, the Commission made clear that the Fairchild reclassification met the requirements for the exemption stated in Rule 16b-3(d): Rule 16b-3(d) "exempts from Section 16(b) liability '[a]ny transaction involving a grant, award or other acquisition from the issuer; if any one of three conditions is met.'" (App. at 71a.) Those conditions were entirely satisfied in this case when Plaintiff alleged in his Complaint that the reclassification was approved by written consent of the owners of the majority of Fairchild's securities. (App. at 71a.)

As the Commission noted, the requirement created by the court of appeals — that the transaction have a compensatory purpose — "does not appear in the rule." (App. at 71a.) The "only limitations on the exemption for transactions between the issuer and its officer or director are those objective conditions set forth" in the rule. (App. at 70a-71a.) Those conditions were met in this case. (App. at 70a.) Thus, by injecting this new requirement, the court of appeals' analysis "runs directly contrary to the Commission's stated reasons for adopting the exemption" and is an "incorrect reading of the Commission's intent." (App. at 72a.)

The Commission further explained that it was not the "compensatory nature of the transactions that made them suitable for exemption," but the lack of potential for speculative abuse. (App. at 72a.) The Commission explained the rationale for the rule at the time of its adoption:

> "Typically, . . . where the issuer, rather than the trading markets, is on the other side of an officer or director's transaction in the issuer's equity securities, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute."

(App. at 72a-73a (quoting 1996 Adopting Release, 1996 WL 290234, at *3).)

In expressly rejecting any continuing "compensatory nexus" requirement, the Commission focused on the "'objective gate-keeping' conditions" expressly set forth in Rule 16b-3, including approval by the issuer's board or shareholders. It stated:

> The Commission viewed satisfaction of one of these gate-keeping conditions, not the compensatory nature of the transaction, as providing the necessary

> protection to justify exemption under Rule 16b-3(d). Accordingly, the Commission stated that under the new rule "unlike the current rule, a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element."

(App. at 73a (quoting 1996 Adopting Release, 1996 WL 290234, at *4).)[9]

The Commission emphasized that the court of appeals' holding — that the rule requires a compensatory purpose — frustrated an important intent of the Commission in drafting the new rule: to make it simpler. Parties who, prior to the decision of the court of appeals, could clearly ascertain if a transaction satisfied one of the objective Rule 16b-3(d) "gate-keeping" conditions, are now no longer able to do so. (App. at 75a.)

---

9. The Commission specifically criticized the Third Circuit's distortion of this language:

> Although the panel quoted this language, it seized on the use of the word "specifically" as implying that the grant, award, or other acquisition nevertheless must have some relation to compensation. ***That, however, was not the Commission's intention, and it is a reading that runs counter to the Commission's explanation of the rationale for the rule.***

(App. at 73a-74a (emphasis added).)

2. Rule 16b-7

a. The rule and the Commission's interpretative releases leave no doubt that the reclassification is exempt.

As originally promulgated, Rule 16b-7 exempted the acquisition of stock in a merger or consolidation in which one company already owned at least 85% of the assets or stock of the other company involved. *See Adoption of Rule X-16b-7*, Exchange Act Release No. 34-4,717, 1942 WL 7278, at *1 (June 9, 1952). In proposing the rule, the Commission explained that these types of transactions do not present "significant opportunities" for speculative abuse because they should be viewed as "merely the technique used to give effect to a routine business judgment" and that while the "form of [the shareholders'] holdings" changes it does so "without affecting the substance of their interest in the enterprise." *Certain Acquisition and Dispositions of Securities Pursuant to Mergers and Consolidations*, Exchange Act Release No. 34-4,696, 1952 SEC LEXIS 63, at *5 (Apr. 1952).

In a 1981 interpretative release, the Commission explained that, although the rule at that time spoke only of mergers and consolidations, it could also be applied to other "substantivel[y] equivalent" transactions "not specifically mentioned" in the rule. *Rules Applicable to Insider Reporting and Trading*, Exchange Act Release No. 34-18,114, 1981 WL 31301, at *57 (Sept. 24, 1981) (the "1981 Interpretive Release") (Question 142). In particular, the Commission explained that "Rule 16b-7 does not require that the security received in exchange be similar to that surrendered, and the rule can apply to transactions involving reclassifications." *Id.*

In 1991, the Commission amended Rule 16b-7 to include "reclassifications" expressly within the rule's title. *See Ownership Reports and Trading by Officers, Directors, and Principal Security Holders*, Exchange Act Release No. 34-28,869, 1991 WL 292000, at *51 (Feb. 21, 1991). In the 1991

adopting release, the Commission explained that the title change did not effect a substantive change to the rule. *Id.* at *31-32. In effect, the Commission added reclassifications to the title of Rule 16b-7 to codify its long-standing interpretation that Rule 16b-7 exempted reclassifications that are the substantive equivalent of the exempted mergers and consolidations.

b. The Commission's no-action letters make clear that the Fairchild reclassification is exempt.

The Commission confirmed its view about the exempt status of reclassifications such as the one at issue in this case in *Monk Austin, Inc.*, SEC No-Action Letter, 1992 Fed. Sec. L. Rep. (CCH) ¶ 76,296, 1992 WL 337451 (Nov. 19, 1992). That no-action letter involved a reclassification virtually identical to the Fairchild reclassification. In *Monk-Austin*, a closely-held corporation, with the approval of its board of directors and shareholders, proposed a reclassification of its three classes of outstanding stock (Class A common, non-voting Class B common, and non-voting preferred) into a single, new class of common stock to facilitate an IPO. 1992 WL 337451, at *1. Each share of Class A common stock and Class B common stock was to be converted into an equal number of shares of the new common stock, and (like here) the conversion ratio of preferred stock to common was determined by dividing the liquidation value of the preferred stock by the price at which the new common stock would be sold in the IPO. *Id.*

The Commission agreed that the proposed reclassification would be exempt under Rule 16b-7 because it was not "subject to insider abuse and [would] not [effect] a substantive change in the investment of any shareholder in the Company." *Id.* at *4. The purpose of the transaction was "to change the capital structure in preparation for an IPO and not to change the

economic or other nature of [the shareholders'] investment in the Company." *Id.* at *3.

Similarly, in *St. Charles Acquisition Ltd. Partnership*, SEC No-Action Letter, 1992 Fed. Sec. L. Rep. (CCH) ¶ 76,223, 1992 WL 146565 (June 25, 1992), the owners of a partnership wanted to transform it into a corporation and conduct an IPO. 1992 WL 146565, at *1-2. The partners planned to exchange their general and limited partnership interests for proportionate amounts of common stock, some of which they would then sell in the IPO. *Id.* Noting that the proposed reclassification would be unquestionably exempt under Rule 16b-7 if structured as a merger, the partners requested a no-action letter from the Commission, arguing that the "difference in form should [not] cause a different result under Rule 16b-7." *Id.* at 2.

The Commission agreed that the proposed transaction was "eligible for exemption pursuant to Rule 16b-7(a)." *Id.* at *5. The Commission noted in particular the partners' representation that their "aggregate percentage interests . . . in the Company following the exchange for common stock . . . will be the same as their aggregate percentage interest in [the partnership]." *Id.* at *4-5.[10]

In terms of the risk of speculative abuse, the Fairchild transaction is indistinguishable from the transactions at issue in *Monk-Austin* and *St. Charles*.[11]

---

10. Despite Defendants' heavy reliance below on the *St. Charles* ruling, the court of appeals failed to cite it, let alone to attempt to distinguish it.

11. The Commission's no-action letters were entitled, at a minimum, to *Skidmore*-style deference. *See Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

c. In this case, the Commission flatly rejected the court of appeals' re-writing of Rule 16b-7.

The court of appeals found that Rule 16b-7 does not apply to reclassifications that either alter the characteristics of the investment or result in increasing proportional ownership of common stock. 314 F.3d at 116-18. In its *amicus* brief, however, the Commission made clear its view that this ruling "went beyond the terms of the rule and the Commission's intent in adopting the rule." (App. at 75a.) According to the Commission, the Fairchild reclassification was "exempt from Section 16(b) by virtue of Rule 16b-7." (App. at 75a.)

As to whether a reclassification alters the characteristics of an investment, the Commission noted its own previous statement, in an interpretive release, that "Rule 16b-7 does not require that the security received in exchange be similar to that surrendered." (App. at 77a (quoting 1981 Interpretive Release, 1981 WL 31301, at *57).) The Commission explained:

> To interpret Rule 16b-7 to require the securities received to have the same risk characteristics as those exchanged is contrary to the language of the rule and introduces elements of subjectivity that would make it difficult to plan transactions in reliance on the exemption.

(App. at 80a.)

As for whether a reclassification increases proportionate interest in common stock, the Commission noted that Rule 16b-7

> by its terms exempts acquisitions that satisfy either 85% cross-ownership test. Where a merger involves a parent company buying out the remaining 15% of

> the other company's stock, the percentage ownership of the prior owners in the merged entity is going to change. Yet that fact does not mean the rule is unavailable.

(App. at 79a.) Thus, the Commission explained, the court of appeals' decision "inappropriate[ly]" imposed on reclassifications "conditions that would not apply to mergers." (App. at 78a.) Indeed, the Commission noted that in this case:

> The insiders' investment in the company did not change. Their common stock position increased only to the extent the reclassification converted preferred stock into common stock. As a result of the transaction, their preferred stock interest declined to zero because the recapitalization extinguished the entire class. As the district court noted, and the panel did not dispute, these transactions presumably involved exchanges of financial interests of equivalent value. . . . The percentage of common stock increased, but a financially equivalent amount of preferred stock was given up. Overall, the value of the insiders' investment in the company did not change substantially, if at all.

(App. at 79a.) In fact, noted the Commission, by

> imposing [these] requirement[s], the panel assured that few reclassifications will be exempt under Rule 16b-7, since almost all reclassifications have at least one, and usually both of the characteristics that the court found disqualifying. Indeed, if the original security and the security for which it is being exchanged were precisely the same, there typically would be little need for a reclassification at all.

(App. at 75a-76a.)

In response to the court of appeals' concern that Rule 16b-7 did not "contain standards for reclassifications," the Commission observed that the "standards for mergers and consolidations have been applied to reclassifications." (App. at 77a.) A reclassification "is little different from a merger exempted by Rule 16b-7." (App. at 78a.)

> In both cases, all stock in a class is exchanged on terms that have been approved by the board and/or shareholders. The exchange occurs on a class-wide basis. In the case of a merger subject to the rule, the combining companies were already 85% cross-owned, so that the combination effects no major change in the acquiring company's business. In a reclassification, the issuing company remains identical — there is no change in the business.

(App. at 78a.) The Commission commented that the distinction in this case between a reclassification and a merger or consolidation is one of form, rather than substance, since the reclassification of Fairchild could have been readily "effected by the issuer creating a new shell company, capitalizing it, merging the old company into the new, and then exchanging stock in the old company for stock in the new." (App. at 78a.)

The Commission explained that, since the Commission's promulgation of Rule 16b-7, "the Commission staff construed it as also applying to reclassifications." (App. at 76a-77a.) That position was expressly strengthened with the 1981 Interpretive Release, and again with the 1991 amendment of the title of the rule to include "Reclassifications." (App. at 77a.) The Commission stated that the court of appeals' decision took a completely different and disfavored approach, one which imported a return to early litigation where courts dealt with the applicability of section 16(b) "by examining, on a case-by-case basis, whether the reclassification posed a risk of insider abuse." (App. at 76a.)

For all of these reasons, the Commission concluded that the court of appeals' "analysis misapplies and misconstrues the rule." (App. at 78a.)

* * * * *

Notwithstanding this Court's clear precedent, the court of appeals interpreted the Commission-created exemptions to section 16(b) liability in a manner that the Commission has criticized as "misconstru[ing] the Commission's intent, and . . . frustrat[ing] the Commission's purpose in adopting the rules." (App. at 68a.) In so doing, the court of appeals violated two of the most basic principles that have been laid down in this area by this Court.

First, Rules 16b-3(d) and 16b-7 are the product of express congressional authorization. On their face, they exempt the Fairchild reclassification from section 16(b) liability. Yet the court of appeals flatly ignored the plain language of those rules. This stark refusal to apply the rules as written violated the law of this Court as set forth in *Chevron*.

Second, even if there were doubt about the facial meaning of the rules, the court of appeals' interpretation of Rules 16b-3(d) and 16b-7 directly conflicts with the Commission's interpretation of its own rules as set forth in its interpretive releases, no-action letters, and its *amicus* brief in this case. For example, the court of appeals engrafted a compensatory purpose requirement onto Rule 16b-3(d), despite the Commission's statement in the adopting release that exemption did not require a compensatory purpose. And the court of appeals' interpretation that Rule 16b-7 does not exempt the Fairchild reclassification directly contradicts the Commission's position in its *amicus* brief that it does.[12] This rejection of the

12. The Commission's interpretation of its own regulation, set forth in an brief *amicus curiae*, is controlling unless it is plainly erroneous or inconsistent with the regulation. *Levy v. Southbrook Int'l Invs., Ltd.*, (Cont'd)

Commission's interpretations of its own regulations contravenes this Court's decisions in *Auer v. Robbins*, 519 U.S. 452, 461 (1997), and *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945), which expressly hold that an agency's interpretation of its own regulations is controlling unless plainly erroneous or inconsistent with the regulation.

Accordingly, the decision of the court of appeals squarely conflicts with this Court's prescription for the controlling weight to be given to agency rules and an agency's interpretation of its own regulations. Consequently, it attacks the very structure this Court has created over decades to govern the deference owed to agency determinations.

C. The Decision Below Creates a Conflict Between the Second and Third Circuits.

Wholly apart from the issues created by the conflicts between the court of appeals' interpretation of the Commission's rules and the Commission's own interpretation, this case also squarely presents a conflict between the Third Circuit and the Second Circuit with regard to Rule 16b-3(d).

Months before the Third Circuit's decision in this case, the Second Circuit decided a case involving Rule 16b-3(d), *Gryl v. Shire Pharmaceuticals Group PLC*, 298 F.3d 136 (2d Cir. 2002). In *Gryl*, the Second Circuit applied Rule 16b-3 to hold exempt a transaction in which stock options held by directors in one corporation were automatically converted into stock options in a second corporation at the time of a merger. *Id.* at 139.

(Cont'd)

263 F.3d 10, 14 (2d Cir. 2001); *see also Auer v. Robbins*, 519 U.S. 452, 461-62 (1997) (holding that Secretary of Labor's interpretation of "the Secretary's own regulations," set forth in an *amicus* brief, is controlling).

Less than six months later, the individual defendants exercised the new options and sold the shares. *Id.*

The Second Circuit affirmed the dismissal of the section 16(b) claim on the basis that Rule 16b-3(d) exempted the conversion. *Id.* at 140. Not surprisingly, the court, in reaching its decision, did not require a finding of compensatory purpose. Rather, focusing on the actual language of the current Rule 16b-3(d)(1) — which it dubbed the "Board Approval Exemption" — the Second Circuit held that the exemption has only three requirements: (1) the defendant must "acquire" issuer securities from the issuer; (2) the defendant must be a director or officer of the issuer at the time; and (3) the transaction must be approved in advance by the issuer's board of directors. *Id.* at 141. Obviously, none of these three elements requires a compensatory purpose. Under the Second Circuit's interpretation of Rule 16b-3, the reclassification in this case would be indisputably exempt.

In this case, the court of appeals attempted to bring *Gryl* into harmony with its own analysis by trying to recast the transaction in *Gryl* as one in which the stock options "had a compensatory nexus." *Levy*, 314 F.3d at 124. However, the "short swing" in *Gryl* was the period between the acquisition of the stock options in the new company *pursuant to the merger* and their subsequent sale. Whatever "compensatory nexus" may have existed in connection with the *initial issuance* of the options was simply irrelevant to the later transaction in question. The court of appeals' interpretation of Rule 16b-3(d) to require a "compensatory nexus" is squarely at odds with the interpretation of the same rule by the Second Circuit.

D. The Issues Presented by the Conflicts Are Recurring and of Great Practical Importance.

The conflicts presented squarely by this case — (i) between the Third Circuit and the plain language of the Commission's duly-authorized rules, (ii) between the Third Circuit and the

Commission as to the interpretation of those rules, and (iii) between the Third Circuit and the Second Circuit regarding the proper interpretation of Rule 16b-3(d) — are of real practical significance. The decision challenges the authority of the Commission to promulgate and administer a clear set of rules for the public to follow. Indeed, the importance of this case is underscored by the Commission's strongly expressed statement in the court of appeals and the complete lack of deference with which it was received.

If left unresolved, the conflicts present in this case will undermine the predictability that the Commission's rule-making was intended to ensure. As the Commission has made plain, both Rules 16b-3 and 16b-7 were intended to provide clear, simple guidance as to which transactions are outside the scope of section 16(b) liability. The rules were intended to avoid the very case-by-case judicial inquiry that the court of appeals decision would require. The decision deprives parties planning business transactions of clear guidelines, and raises the specter that the rules may be different not only in different circuits, but also, at least initially, within circuits, as case-by-case adjudication produces inconsistent results.

In a long line of cases dating back to the creation of the Commission in the 1930's, this Court has held that the agency's rules themselves, and the agency's interpretation of those rules, should control. If this decision is left standing, it will undercut the ability of the Commission to use its special, technical knowledge in financial transactions to administer section 16(b) in a uniform manner. That, in turn, may well create a lack of confidence in the public's ability to rely upon the validity of Commission conduct and guidance, not only with respect to section 16(b), but across a much broader spectrum. Such uncertainty is harmful to the nation's markets and the ability to provide predictability for those engaged in business activity.

Moreover, the adverse impact of the decision below is apt to be felt immediately. The move away from reliance on the carefully crafted agency regulatory scheme, which focuses on broad classes of transactions, toward an emphasis on a judicially supervised, fact-intensive, case-by-case inquiry represents a dramatic shift in the law. This about-face will further burden the courts, confuse the public, and likely produce conflicting and inconsistent results. Accordingly, there is a critical need at this time for this Court to address the decision below.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

STEVEN B. FEIRSON
Counsel of Record
FRANCES S. COHEN
GEORGE M. GOWEN III
DECHERT LLP
4000 Bell Atlantic Tower
1717 Arch Street
Philadelphia, PA 19103
(215) 994-4000

Counsel for Petitioner
Sterling Holding Company, LLC

PAUL VIZCARRONDO, JR.
MICHAEL A. CHARISH
WACHTELL, LIPTON, ROSEN & KATZ
51 West 52nd Street
New York, NY 10019
(212) 403-1000

Counsel for Petitioner
National Semiconductor Corporation

APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT FILED DECEMBER 19, 2002

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 02-1698

MARK LEVY,

Appellant

v.

STERLING HOLDING COMPANY, LLC.; NATIONAL SEMICONDUCTOR CORPORATION; FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.

On Appeal from the United States District Court
for the District of Delaware
(D.C. Civ. No. 00-00994)
Honorable Gregory M. Sleet, District Judge

Argued October 29, 2002

BEFORE: NYGAARD, GREENBERG, and MICHEL,*
Circuit Judges

(Filed December 19, 2002)

* * *

---

* Honorable Paul R. Michel, Judge for the United States Court of Appeals for the Federal Circuit, sitting by designation.

Appendix A

OPINION OF THE COURT

GREENBERG, *Circuit Judge.*

I. INTRODUCTION

This matter comes on before this court on an appeal from an order granting a motion to dismiss for failure to state a claim on which relief may be granted entered in the district court on February 5, 2002. Plaintiff-appellant, Mark Levy, a shareholder in Fairchild Semiconductor International, Inc. ("Fairchild"), a nominal defendant-appellee not participating in this appeal, brought this shareholder derivative action on November 28, 2000, against defendants-appellees Sterling Holding Co. ("Sterling") and National Semiconductor Corp. ("National") after Fairchild declined to initiate a lawsuit seeking relief for the matters of which Levy complains. Levy by this action seeks a judgment requiring Sterling and National to disgorge what he alleges were "short-swing insider trading profits of more than $72 million" in Fairchild stock. Levy predicates the action on section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), which deprives specified insiders from profiting from certain offsetting purchase and sale securities transactions completed within less than a six-month period. The district court had jurisdiction under section 27 of the Exchange Act, 15 U.S.C. § 78aa, and we have jurisdiction under 28 U.S.C. § 1291. We exercise plenary review on this appeal. *See Gallo v. City of Philadelphia,* 161 F.3d 217, 221 (3d Cir. 1998).

Appendix A

II. HISTORY

In view of the procedural posture of the case we take the facts from Levy's allegations. On March 11, 1997, National spun off Fairchild pursuant to an Agreement and Plan of Recapitalization. At that time National retained in Fairchild 4,380,000 shares of Class A common stock, 5,243,621 shares of Class B common stock (as measured after a four-for-one common stock split on April 29, 1998), and 11,667 shares of 12% Series A cumulative compounding preferred stock. Sterling, on or around the same date, purchased for $58.5 million approximately 3,553,000 shares of Class A common stock, 7,099,000 shares of Class B common stock (as measured after the split), and 53,113 shares of 12% Series A cumulative compounding preferred stock in Fairchild.

On July 1, 1999, a majority of Fairchild's common and preferred shareholders voted to convert all shares of its preferred stock into Class A common stock "automatically" upon completion of a contemplated Initial Public Offering (IPO). Inasmuch as the preferred shares previously had not been convertible into common stock, an amendment of Fairchild's certificate of incorporation was required to effectuate the conversion.[1] On July 26, 1999, a majority of the shareholders of all three classes of Fairchild stock approved by written consent a restatement of Fairchild's certificate of incorporation containing an amendment authorizing the conversion. In accordance with a formula in the amendment each share of preferred stock was worth 75.714571 shares of class A common stock. Upon completion of the IPO on August 9,

1. We were told at oral argument that the conversion was undertaken because the existence of the preferred stock would have been an impediment to the IPO.

1999, Sterling and National respectively acquired 4,021,428 and 888,362 shares of Class A common stock. Levy alleges that the conversion of preferred stock into common stock constituted a non-exempt "purchase" by National and Sterling within the meaning of section 16(b) of the Exchange Act.

On January 19, 2000, within six months after the alleged purchase (the conversion), Sterling sold 11,115,000 shares of class A common stock for a profit of $58,511,777, and National sold 7,243,360 shares of class A common stock for a profit of $14,124,958. Levy's complaint alleges that "[t]hese sales are matchable against the purchases [conversions] alleged." While we have some difficulty understanding why there is a matchable situation here in view of Sterling's and National's earlier ownership of class A common stock, we nevertheless at this time accept the allegation as true.

National and Sterling have or had officers who sat on Fairchild's seven-member board of directors pursuant to a Stockholder's Agreement. The agreement, dated March 11, 1997, provided that Sterling would designate two of Fairchild's directors and two of Fairchild's independent directors (subject to the veto of Fairchild's chief executive officer), and that National, if it continued to hold stock in Fairchild, would designate one director who was an executive officer of National. At the times relevant to this action, Fairchild's directors included Sterling's chairman and chief executive officer, the president of Citicorp Venture Capital Ltd. which, Levy alleges, owns an interest in Sterling,[2] and a

2. Sterling's disclosure statement included in its brief on this appeal pursuant to Fed. R. App. P. 26.1 and Third Circuit LAR 26.1(b) recites that Citicorp Venture Capital Ltd. owns Sterling.

managing director of Citicorp Venture Capital. In addition, an individual who served as the president, chief executive officer and chairman of National, was on the Fairchild board.

According to a Fairchild prospectus filed on August 4, 1999, National owned 14.8% of Fairchild's class A common stock and 14.9% of class B common stock and Sterling owned 48.0% of its class A common stock and 85.1% of its class B common stock. For this and other reasons, Levy made the uncontroverted allegation that National and Sterling were beneficial owners of more than 10% of Fairchild's outstanding stock.

III. DISCUSSION

A. Was the reclassification exempted by Rule 16b-7 from section 16(b) or otherwise not included in the section?

1. *Statutory Background*

Section 16(b) of the Securities Exchange Act of 1934 requires that any profits earned by insiders through "short-swing" trading must be disgorged, or returned to the issuer of the security. The section provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of

> such issuer (other than an exempted security) or a security-based swap agreement . . . involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement . . . or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

15 U.S.C. § 78p(b).

Appendix A

The Supreme Court has explained the purpose of section 16(b):

> The general purpose of Congress in enacting § 16(b) is well known. . . . Congress recognized that insiders may have access to information about their corporations not available to the rest of the investing public. By trading on this information, these persons could reap profits at the expense of less well informed investors. In § 16(b) Congress sought to 'curb the evils of insider trading (by) . . . taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great.' . . . It accomplished this by defining directors, officers, and beneficial owners as those presumed to have access to inside information and enacting a flat rule that a corporation could recover the profits these insiders made on a pair of security transactions within six months.

Foremost-McKesson Inc. v. Provident Sec. Co., 423 U.S. 232, 243-44, 96 S.Ct. 508, 516 (1976) (citing *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 591-92, 93 S.Ct. 1736, 1742-43 (1973), and citing and quoting *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422, 92 S.Ct. 596, 599 (1972)) (footnote omitted).

Section 3(a)(13) of the Securities Exchange Act provides that "[t]he terms 'buy' and 'purchase' each include any contract to buy, purchase, or *otherwise acquire*" any equity security. 15 U.S.C. § 78c(a)(13) (emphasis added).

In applying this definition in the section 16(b) context, the Supreme Court has said, "[t]he statutory definitions of 'purchase' and 'sale' are broad and, at least arguably, reach many transactions not ordinarily deemed a sale or purchase." *Kern County Land Co.*, 411 U.S. at 593-94, 93 S.Ct. at 1744.

Thus, section 16(b) of the Exchange Act, by requiring insiders to disgorge any profits earned as a result of their short-swing trading of an equity security without regard to their intent, "imposes a strict prophylactic rule" of "liability without fault within its narrowly drawn limits," *Foremost-McKesson,* 423 U.S. at 251, 96 S.Ct. at 519, to protect against insiders engaging in speculative abuse.

Nevertheless, section 16(b) has its limits and not every transaction that could fall within the definition of "purchase" or "sale" is so treated by that section. Thus, the Exchange Act provides that the SEC may exempt certain transactions from the coverage of the statute. *See* 15 U.S.C. § 78p(b) (The statute "shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."). Furthermore, the Supreme Court has explained that, as to certain "unorthodox" or "borderline" transactions not meeting the usual definition of purchase or sale, "the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent — the realization of short-swing profits based upon access to inside information." *Kern County Land Co.*, 411 U.S. at 594, 93 S.Ct. at 1744; *see also id.* n.26, 93 S.Ct. at 1744 n.26 ("By far the greater weight of authority is to the effect that a 'pragmatic' approach

to § 16(b) will best serve the statutory goals."); *Reliance Elec. Co.*, 404 U.S. at 424 n.4, 92 S.Ct. at 600 n.4 ("In interpreting the terms 'purchase' and 'sale,' courts have properly asked whether the particular type of transaction involved is one that gives rise to speculative abuse.").

The elements of a claim under section 16(b) are that "there was (1) a purchase and (2) a sale of securities (3) by an officer or director of the issuer or by a shareholder who owns more than ten percent of any one class of the issuer's securities (4) within a six-month period." *Gwozdzinsky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir. 1998). There is no dispute on this appeal as to National's and Sterling's status as insiders or beneficial owners of ten percent or more of the stock and it is undisputed that there were "sales" within the meaning of section 16(b) that occurred within six months of the alleged (and vigorously disputed) "purchases." Thus, the issue on this appeal is whether the "reclassification" transactions upon the conversion of the preferred stock into common stock were non-exempt "purchases" within section 16(b) of the Act. While we recognize that Sterling and National are discrete entities, inasmuch as they appear, at least at this point in the case, to be in the same position, as a matter of convenience we will refer to their "purchases" and "sales" singularly.

2. *Does Rule 16b-7 exempt reclassifications generally from liability under section 16(b)?*

We are satisfied that SEC Rule 16b-7, 17 C.F.R. § 240.16b-7, in which the SEC exercises its authority to exempt transactions from section 16(b) does not exempt

reclassifications categorically from the section. Our conclusion in this regard differs from that of the district court which determined that Rule 16b-7 exempted reclassifications of stock from the reach of section 16(b) so that a reclassification could not be the opening or purchase leg of a swing transaction subject to section 16(b). It was, of course, this conclusion that led it to grant National's and Sterling's motions to dismiss. According to the district court, "[i]n light of the SEC's own interpretation of its rules and regulations, it seems clear the provisions of Rule 16b-7 apply to reclassifications. It would seem then that reclassifications are exempt from the scope of Section 16(b)." *Levy v. Sterling Holding Co.*, C.A. No. 00-994, at 5-6 (D. Del. Feb. 5, 2002).

As we have indicated, section 16(b) explicitly authorizes the SEC to exempt "any transaction . . . as not comprehended within the purpose of" the statute. This section is critical for courts defer to an agency's interpretation of statutes, particularly where the statute provides the agency with authority to make the interpretation. *See Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44, 104 S.Ct. 2778, 2781-82 (1984). In this case, however, the SEC has not set forth its interpretation clearly so our threshold challenge is to ascertain what in fact was its interpretation.

The text of Rule 16b-7, including its title, states:

> § 240.16b-7 Mergers, reclassifications, and consolidations.
>
> > (a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

Appendix A

(1) The acquisition of a security of a company, pursuant to a merger or consolidation, in exchange for a security of a company which, prior to the merger or consolidation, owned 85 percent or more of either

(i) The equity securities of all other companies involved in the merger or consolidation, or in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies involved in the merger or consolidation, computed according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation, or such shorter time as the company has been in existence.

(2) The disposition of a security, pursuant to a merger or consolidation, of a company which, prior to the merger or consolidation, owned 85 percent or more of either

(i) The equity securities of all other companies involved in the merger or consolidation or, in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies undergoing merger or consolidation, computed according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation.

(b) A merger within the meaning of this section shall include the sale or purchase of substantially all the assets of one company by another in exchange for equity securities which are then distributed to the security holders of the company that sold its assets.

(c) Notwithstanding the foregoing, if a person subject to section 16 of the Act makes any non-exempt purchase of a security in any company involved in the merger or consolidation and any non-exempt sale of a security in any company involved in the merger or consolidation within any period of less than six months during which the

> merger or consolidation took place, the exemption provided by this Rule shall be unavailable to the extent of such purchase and sale.

17 C.F.R. § 240.16b-7. A leading securities law treatise describes Rule 16b-7 as follows:

> Rule 16b-7 was initially adopted in 1952. . . . Its theory is that certain types of mergers and the like are of relatively minor significance to the stockholders of the liquidated corporation and present no significant opportunities for trading on the basis of advance information concerning the prospect of a merger. . . . To provide for such cases, Rule 16b-7 exempts transactions incident to a merger . . . or a consolidation when the surviving company was owned to the extent of at least 85 percent by the liquidated company, or when the company whose security is given up held over 85 percent of the combined assets of all the companies undergoing merger or consolidation.

5 L. LOSS & J. SELIGMAN, SECURITIES REGULATIONS § 6(E)(8)(e)(x), at 2474 (3d ed.2001).

Inexplicably, though the title of Rule 16b-7 includes "reclassifications," the text of the rule does not mention the term. While National and Sterling acknowledge this omission, they argue that nevertheless the inclusion of "reclassifications" in the title demonstrates the SEC's intent. In this regard we point out that even though the SEC added the word "reclassifications" to the title of Rule 16b-7 when

amending the rule in 1991 without providing a reason for the change, *see* Ownership Reports and Trading, Exchange Act Release No. 34-28869, 56 Fed. Reg. 7242, 7273 (Feb. 8, 1991), it seems unlikely that it did so for no reason. Unfortunately, however, the title and text of the rule, standing alone, do not provide us assistance in our effort to ascertain the SEC's purpose.[3]

In addition to relying on the title of Rule 16b-7 to support its argument that the rule includes reclassifications which thus are exempt from section 16(b), National and Sterling point to an interpretive release that the SEC issued in 1981. Question 142 of this release, and the SEC's answer, both concern reclassifications in part:

> (142) Question: Although not specifically mentioned, does Rule 16b-7 apply to transactions

---

3. The proposing releases for the 1991 amendment to Rule 16b-7 do not shed much light either. In one of the proposing releases, the SEC explained that, to address the "very high" "rate of delinquency in Form 3 and 4 filings," it proposed, in part, to "[s]implify[] the reporting provisions to focus on timely reporting of those securities transactions that are more discretionary in nature and have greater potential for abuse[,]" Ownership Reports and Trading by Officers, Directors and Principal Stockholders, Exchange Act Release Nos. 34-26333, 35-24768, 53 Fed.Reg. 49997, 50000 (Dec. 13, 1988), and to that end, would propose, "[a]s part of the effort to make the rules less complex, minor language changes to some of the current rules." *Id.* at 50000 n. 41. National also cites to a second release proposing amendments to the SEC's rules, *see* Ownership Reports and Trading, Exchange Act Release No. 34-27148, 35-24942, 54 Fed. Reg. 35667 (Aug. 29, 1989), but this release only identifies the addition of the word "reclassifications" without providing any reason for the change.

> structured as (1) statutory exchanges; (2) liquidations; or (3) *reclassifications*?
>
> Answer: The staff is of the view that, for purposes of Rule 16b-7, a statutory exchange may be the substantive equivalent of a merger, consolidation or sale of assets. Therefore, the acquisition and disposition of stock in a statutory exchange would be exempt under Rule 16b-7, assuming all of the conditions of the rule are satisfied. . . . A liquidation on the other hand, is not covered by Rule 16b-7 since the liquidation in substance and purpose bears little resemblance to the types of transactions specified in the rule. . . . Rule 16b-7 does not require that the security received in exchange be similar to that surrendered, and *the rule can apply to transactions involving reclassifications.*

Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 34-18114, 46 Fed. Reg. 48147, 48176-77 (Sept. 24, 1981) (emphasis added) (footnotes omitted). Levy asserts that the release, by referring to "transactions involving reclassifications," and making the permissive statement that the rule "can apply to . . . reclassifications," suggests that Rule 16b-7 does not provide a blanket exemption for all reclassifications as the answer that the rule "can apply" to reclassifications suggests that sometimes it does not so apply. Appellant's Br. at 15. Levy further notes, correctly, that the illustrative examples contained in Question 142 of the release do not discuss reclassifications. *Id.* at 16.

National takes a different approach as it claims in its brief that the SEC asserted that the amendment of the title of Rule 16b-7 "made no substantive changes to the rule, thereby acknowledging that Rule 16b-7 already exempted stock reclassifications." National Br. at 15 (citing Rules Applicable to Insider Reporting and Trading, Exchange Act Release Nos. 34-28869, 35-25254, 56 Fed. Reg. 7242, 7261 (Feb. 21, 1991)). This argument, however, misconstrues the SEC's announcement as National merely points to a statement in a chart comparing the old and new rules indicating that there was no substantive change in Rule 16b-7. A conclusion that there was no change does not tell us what the rule meant before the amendment.

National and Sterling also cite the SEC's proposed amendments to Form 8-K, which governs reporting requirements for officer and director transactions. *See* Form 8-K Disclosure of Certain Management Transactions, Release No. 33-8090, 34-45742, 67 Fed. Reg. 19914 (Apr. 23, 2002). The SEC proposed an exemption from reporting requirements for transactions that "do not generally appear to reflect management's views of the company's prospects or sever the link between executive compensation and company equity securities performance." *Id.* at 19919. This set of transactions exempt from reporting requirements included "[a]cquisitions or dispositions pursuant to holding company formations and similar corporate reclassifications and consolidations." *Id.* The release indicates that these "are the transactions exempted from Section 16(b) short-swing profit recovery by Exchange Act Rule 16b-7." *Id.* n.56. Thus, this release also indicates that the SEC considers that certain reclassifications are exempt under Rule 16b-7. But the release does not suggest

that all reclassifications are *per se* exempt. Indeed, the release clearly hedges on the point and thus supports a conclusion that some but not all reclassifications are exempt from section 16(b)'s restrictions.

Overall, we are satisfied from our review of the text of Rule 16b-7 and the SEC releases that we have discussed offering the SEC's partial interpretations of the rule that the SEC has not included all reclassifications in Rule 16b-7 and thus has not exempted *all reclassifications* from the reach of section 16(b). On the other hand, the rule must encompass *some* reclassifications. After all, we hardly can conclude otherwise inasmuch as the 1981 release states that Rule 16b-7 "can apply to reclassifications" and the 1991 amendment included the term "reclassifications" in the title of the rule. This conclusion requires us to determine whether the reclassification here is included in the rule.

3. *Is the reclassification here exempt under Rule 16b-7?*

In the absence of specific SEC guidance about which reclassifications are exempt from section 16(b) under Rule 16b-7, we believe that two principles should guide us in determining which reclassifications should be included in Rule 16b-7. First, just as Rule 16b-7 limits exemptions to certain transactions related to mergers and consolidations, so, too, should it impose analogous limits on exemptions for transactions involving reclassifications. Second, the reclassification exemption should extend only to those "transactions . . . not comprehended within the purpose of" section 16(b). 15 U.S.C. § 78p(b).

Appendix A

The text of Rule 16b-7 does not exempt transactions involving all mergers and consolidations, but rather, a limited class of transactions.[4] As one treatise elaborates,

> The Commission has exempted from Section 16(b) combinations effectuated by merger or the purchase of substantially all corporate assets for stock in certain limited situations. In the event a parent combines with a subsidiary or subsidiaries in which it owns 85 percent of the outstanding equity securities, or if a company combines with other companies in a situation in which it owns 85 percent of the combined assets of all the companies prior to the merger, and the parent (or principal asset owner as the case may be) is not the surviving corporation, the corporate combination does not involve a sale of its securities or a purchase of the surviving corporation securities for purposes of Section 16(b) liability. If the parent (or principal asset owner) is the surviving corporation the rule is not applicable, but on the other hand it is not necessary for Section 16(b) purposes as the corporate combination will not involve a purchase or sale of its shares by its

---

4. *See, e.g.*, Harvey L. Pitt, *Merger and Acquisition Implications, in* A PRACTICAL GUIDE TO SECTION 16: REPORTING AND COMPLIANCE § 11.3 (Amy L. Goodman, ed. 3d ed. 1997 & Supp.2000) ("Rule 16b-7 contains an exemption of the acquisition or disposition of a security of a company pursuant to certain specified types of mergers, consolidations, and reclassifications that do not result in a 'significant change in the character of the structure of the Company.'") (footnotes and citations omitted).

> shareholders unless they are also shareholders in the subsidiary. The staff has refused to extend the rule to the latter situation, stating that it was intended to provide an exemption 'for a limited class of mergers which result in technical rather than substantial changes in the affected securities.'

3D HAROLD BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 21:74 (2d ed. & 2002 supp.) (quoting Xidex Corp., SEC No-Action Letter (Mar. 6, 1995), Fed. Sec. L. Rep. (CCH) ¶ 77,928 (Mar. 6, 1995)).[5] Thus, by its terms Rule 16b-7 applies to

---

5. National cites this treatise to support its claim that Rule 16b-7 applies to reclassifications. National Br. at 21-22 n.3. The treatise states:

> Is a statutory reclassification resulting in the exchange of outstanding shares of a corporation for other shares of the same corporation a sale for purposes of Section 16(b)? Rule 145, discussed at § 3:54, now treats such transactions as involving a sale for purposes of the registration provisions of the Securities Act. The Second Circuit early took the view that it was not a sale for Section 16(b) purposes on the ground that it did not afford insiders an opportunity for speculative abuse. While this view was expressed in 1954, it has been cited with approval by the Second Circuit and it is apparent that it would take unique circumstances to convince the Second Circuit to extend Section 16(b) to such transactions. New Rule 16b-7 applies to reclassifications.

Bloomenthal & Wolff, 3D SECURITIES AND FEDERAL CORPORATE LAW § 21.75 (footnotes omitted). The reference to the Second Circuit was to its decision in *Roberts v. Eaton,* 212 F.2d 82 (2d Cir.1954), which we cite below.

transactions involving the combination of companies where one company owns at least 85% of the other company or companies involved in the transaction; that is, transactions akin to a short-form merger.

National argues that Rule 16b-7 was designed to exempt transactions involving at least "85% cross-ownership" because "such transactions change only the form of a shareholder's investment, not its substance, and thus 'do not present significant opportunities to insiders to profit by advance information.'" National Br. at 15-16 (quoting Exemption of Certain Transactions from Section 16(b), Exchange Act Release No. 34-4696, 17 Fed. Reg. 3177, 3177 (Apr. 10, 1952)). According to National, "[r]eclassifications change the form of a shareholder's investment, not its substance, and do not materially alter the character of the enterprise," and, because a reclassification involves the "exchange of securities of the *same* company," there is "100% cross-ownership, so to speak." *Id.* at 16 (emphasis in original).

National and Sterling both cite the SEC's no-action letter[6] in *Monk-Austin*, SEC No-Action Letter, 1992 WL 337451 (Nov. 19, 1992), in support of their positions. But "SEC no-

6. Usually issuance of a "no-action" letter means that the SEC does not intend to undertake an enforcement action against the party requesting and receiving such a letter. In this context, then, the term "no action" letter is not precisely accurate, insofar as the Act does not authorize the SEC to enforce section 16(b); rather, that task is left to the issuer of the security, or an owner of the security (e.g., a shareholder). *See Gollust v. Mendell*, 501 U.S. 115, 122, 111 S.Ct. 2173, 2178 (1991).

action letters constitute neither agency rule-making nor adjudication and thus are entitled to no deference beyond whatever persuasive value they might have." *Gryl ex rel. Shire Pharms. Group PLC v. Shire Pharms. Group PLC*, 298 F.3d 136, 145 (2d Cir. 2002) (citations omitted). In *Monk-Austin*, the SEC issued a no-action letter expressing its opinion that Rule 16b-7(a) would exempt a recapitalization transaction "pursuant to which the company's capital structure will be changed through the surrender of currently outstanding shares of Class A common stock, Class B common stock and preferred stock in exchange for a new class of Common Stock, in preparation for an initial public offering." *Monk-Austin*, 1992 WL 337451, at *8. The Commission staff explicitly noted "[i]n this regard . . . [the Monk-Austin Company's] representation that shareholders' proportionate interests in the Company will not be changed by the Recapitalization." *Id.*[7]

7. Monk-Austin, in its letter, told the SEC that

> The plan of recapitalization will set forth conversion ratios for the stock. Each outstanding share of preferred stock, which by its terms is currently convertible at the holder's option into shares of current Class B common stock equal in value to the par value of the preferred ($52 per share), will be converted in the Recapitalization into the number of shares of Common Stock determined by dividing $52 by the initial public offering price. Each share of outstanding Class A common stock and each share of outstanding Class B common stock will be converted into an identical, specified number of shares of Common Stock. Thus, *the shareholders' proportionate interests in the Company will be unchanged in the Recapitalization*.

Monk-Austin, 1992 WL 337451, at *1 (emphasis added).

National and Sterling argue that the SEC considered a situation in issuing the *Monk-Austin* no-action letter directly applicable to this case. Levy responds that here, unlike in *Monk-Austin*, National and Sterling did not maintain proportionate interests in Fairchild, but rather, as a result of the conversion of preferred shares into common stock, experienced a change in their proportionate interests. Appellant's Br. at 19-20.[8] Levy also seeks to distinguish *Monk-Austin* on the basis that, whereas in *Monk-Austin*, the preferred stock was convertible into common stock, in this case it was not. *Id.* at 20. Levy asserts:

> Thus, at issue here is not the reclassification of one type of common stock into . . . another economically equivalent class of common stock, but rather the change from the set contractual rights of preferred shareholders to that of complete residual equity ownership embodied by common stock. In other words, Defendants acquired an equity interest they did not own prior to the conversion of the Preferred Stock.

Id. Furthermore, Levy argues that "Sterling's proportionate interest in the [Fairchild] Common Stock increase[d] from 48.03% to 52.18% and National Semiconductor's increased from 14.80% to 15.08%." Appellant's Br. at 17. If Levy's

---

8. Levy appears to conflate two distinct issues: (1) whether the particular reclassification transaction is exempted by Rule 16b-7 and (2) whether, under the "unorthodox transaction" doctrine, the reclassification transaction constitutes a purchase within the meaning of section 16(b). As it turns out, however, the two issues conceptually are intertwined.

allegation that there was a proportionate increase in National's and Sterling's interests in Fairchild as a result of the conversion can be substantiated, *Monk-Austin* is distinguishable. Thus, for this reason alone we will not hold by following *Monk-Austin,* in considering this appeal from an order granting a motion to dismiss, that Rule 16b-7 exempts the reclassification in this case from section 16(b).

We believe that there is a second independent reason why we should not regard, at least at this time, the reclassification here as being within Rule 16b-7. It is undisputed that the preferred stock was not convertible into common stock before the July 26, 1999 amendment to Fairchild's certificate of incorporation. We are of the view that at this stage of the proceedings we must regard the conversion of the preferred stock pursuant to the amendment as the type of reclassification that the SEC would not have intended to exempt by Rule 16b-7. We reach this conclusion for while we do not suggest that the risks and opportunities of shareholders of nonconvertible preferred stock are divorced from the fortunes of the company involved, still they are very different than the risks and opportunities of shareholders holding common stock.

In this regard we point out that preferred shares ordinarily, at least, have a priority claim to dividends. Thus, a diminution in the company's earnings may have less an impact on the value of its preferred shares than on the value of its common shares. On the other hand, if a company prospers the preferred shareholders may benefit little, if at all, for their dividends may be fixed. Thus, both the upside opportunities and downside risks of preferred and common

shareholders are significantly different. While these differences may be lessened when the preferred stock is convertible at the holder's option into common shares, still even in that situation there are differences in risks and opportunities. In this case both the amendment of Fairchild's certificate of incorporation, which made the conversion possible, and the actual conversion took place with the six-month period prior to the January 19, 2000 sales date. In viewing this matter we think that at this time we should regard the reclassification in this case as so changing the risks and opportunities of the preferred shareholders in National and Sterling that the SEC would not have intended to exempt the reclassification from section 16(b) by Rule 16(b)-7. Our conclusion furthers Congress' purpose in enacting section 16(b) by depriving the insiders from obtaining short-swing profits because of their access to information not available to the investing public.

4. *Even if Rule 16b-7 does not exempt the reclassification transaction at issue, is the transaction one that does not constitute a "purchase" within the meaning of section 16(b) of the Securities Exchange Act?*

Of course, our conclusion that the SEC did not intend to exempt all reclassifications from section 16(b) and would not have intended to exempt the transactions here still leaves us with the fundamental question whether, without regard for the SEC's position, the reclassification was a statutory purchase within section 16(b). There is little recent case law on whether reclassifications are section 16(b) purchases. In a footnote in *Kern County Land Co.* the Supreme Court

stated that reclassifications are among those transactions labeled "unorthodox." *See Kern County Land Co.*, 411 U.S. at 593 n.24, 93 S.Ct. at 1744 n.24 ("The term . . . has been applied to stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights, and warrants.") (citing 2 L. LOSS, SECURITIES REGULATION 1069 (2d ed. 1961)).[9] This specific identification of reclassifications confirms that we should undertake the pragmatic analysis that the Supreme Court has described: "the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent — the realization of short-swing profits based upon access to inside information." *Kern County Land Co.*, 411 U.S. at 594, 93 S.Ct. at 1744. As *Kern County* counsels, to determine whether an "unorthodox" transaction constitutes a purchase, a court must ask whether the transaction gives rise to the potential for the type of speculative abuse that Congress enacted section 16(b) to prevent.

Levy cites *Colan v. Mesa Petroleum Co.*, 951 F.2d 1512 (9th Cir. 1991), for the proposition that a changed exposure to market risk is a factor suggesting the potential for speculative abuse. In *Colan*, the Court of Appeals for the Ninth Circuit reversed a district court's grant of summary

9. Often courts treat the term "unorthodox transactions" as meaning transactions that are neither purchases nor sales, and in addition, do not give rise to the potential for speculative abuse. But the term, as described in *Kern*, appears to mean only those transactions that do not meet the usual understanding of purchase or sale and for which it is necessary to engage in the inquiry whether the transactions may allow for speculative abuse.

judgment to the defendants in a case where the plaintiff in a shareholder derivative suit had sued prospective acquirers of a target company for short-swing profit liability under section 16(b). The principal issue was whether an exchange of common stock for debt securities constituted a "sale" under section 16(b). *Id.* at 1518. The court of appeals concluded that the exchange was neither automatic nor involuntary, and determined that the volitional nature of the exchange rendered it a sale under section 16(b). Significantly for our purposes, the *Colan* court emphasized that the "nature of the . . . [d]efendants' investment was changed [as] [t]hey exchanged common stock for negotiable debt securities with a higher market value," thus changing the character of their risk. *Id.* at 1525.

Here, the amendment to the certificate of incorporation provided that the conversion of preferred to common would occur automatically upon the IPO. We recognize, therefore that the conversion itself was thus not voluntary. However, the process by which the certificate was changed was voluntary in the sense that interested parties voted on the question.

Regardless of whether or not the conversion was volitional, however, the question remains whether the transaction had the potential for speculative abuse. We are convinced that we should not hold, as a matter of law, that the transaction lacked that potential. Taking all allegations as true and drawing all reasonable inferences in favor of Levy, it seems at least possible that he can demonstrate the presence of facts consistent with the allegations in the complaint to show that the reclassification transaction had the potential

for speculative abuse. *Cf., e.g., Conley v. Gibson,* 355 U.S. 41, 45-46, 78 S.Ct. 99, 102 (1957) ("[T]he accepted rule [is] that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."). This is particularly so inasmuch as Sterling and National were the dominant shareholders and controlled at least three seats on Fairchild's Board of Directors. *See Roberts v. Eaton,* 212 F.2d 82, 85 (2d Cir. 1954) (contrasting situation in that case to situation "where an insider controls and can work his will through the board of directors") (citing *Park & Tilford v. Schulte,* 160 F.2d 984, 988 (2d Cir. 1947)). We also reiterate that the reclassification involved a conversion of previously nonconvertible preferred stock into common stock that at this stage of the case we must hold materially changed National's and Sterling's risks and opportunities. *See Colan,* 951 F.2d at 1525.[10]

Our conclusion that the district court erred in granting the motion to dismiss is in accord with a recent decision from the District of Delaware contrary to that of the district court here. In *Rosenberg v. Harris Corp.,* No. Civ. A. 01-518-SLR, 2002 WL 1459502 (D. Del. June 10, 2002) (mem.order), the court denied a motion to dismiss in a shareholder derivative lawsuit involving facts remarkably similar to those here. The district court rejected the defendants' argument that the reclassification of Intersil Corp.'s preferred stock into

---

10. In *Colan* the risk was reduced because common stock was exchanged for debt securities but in our view it does not matter whether the conversion enhanced or reduced the risks involved. The point is that the risks were changed.

common stock pursuant to an amended certificate of incorporation, when the conversion took place on the same day as Intersil's IPO, was exempted under Rule 16b-7 from section 16(b) liability. *Id.* at *1-2. The district court observed that:

> with the exception of [the district court's decision in] *Levy,* no court has exempted a reclassification, under the ambit of Rule 16b-7 or otherwise, as a matter of law. Rather, courts have considered the facts and circumstances surrounding each transaction before concluding that a particular transaction did not pose the risk of speculative, insider 'short-swing trading' profits that Section 16(b) sought to prevent.

Id. at *2. The court explained "that the SEC has never expressly exempted all reclassifications from Section 16(b), just as all mergers and consolidations are not exempt — only mergers and consolidations that meet specific, strict guidelines are exempt as a matter of law." *Id.*

In summary we conclude that Rule 16b-7 does not exempt the reclassification from section 16(b) and that the reclassification is not, for other reasons, outside the scope of the section. While we acknowledge that this case is difficult we believe that our result is consistent with Congress' intentions and Rule 16b-7.

B. Does SEC Rule 16b-3 exempt the reclassification?

National and Sterling argue that, even if we do not hold that Rule 16b-7 exempts reclassifications generally or that the transaction here is an exempt reclassification, we nonetheless should affirm the district court on the alternate ground they advanced in that court, but which it had no reason to consider, that SEC Rule 16b-3 exempts the transaction from the rule. Plainly, if we agreed with that contention we would affirm as a court "may affirm a judgment on any ground apparent from the record, even if the district court did not reach it." *Kabakjian v. United States,* 267 F.3d 208, 213 (3d Cir. 2001).

Rule 16b-3, entitled "Transactions between an issuer and its officers or directors," provides, as relevant to this case:

> (a) *General.* A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.
>
> (b) *Definitions.*
>
> > (1) A *Discretionary Transaction* shall mean a transaction pursuant to an employee benefit plan . . .

(2) An *Excess Benefit Plan* shall mean an employee benefit plan that is operated in conjunction with a Qualified Plan . . .

(3)(i) A *Non-Employee Director* shall mean a director who:

(A) Is not currently an officer (as defined in § 240.16a-1(f)) of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer;

(B) Does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to § 229.404(a) of this chapter;

(C) Does not possess an interest in any other transaction for which disclosure would be required pursuant to § 229.404(a) of this chapter; and

Appendix A

(D) Is not engaged in a business relationship for which disclosure would be required pursuant to § 229.404(b) of this chapter.

(ii) Notwithstanding paragraph (b)(3)(i) of this section, a *Non-Employee Director* of a closed-end investment company shall mean a director who is not an 'interested person' of the issuer, as that term is defined in Section 2(a)(19) of the Investment Company Act of 1940.

(4) *A Qualified Plan . . .*

(5) *A Stock Purchase Plan . . .*

(c) *Tax-conditioned plans. . . .*

(d) *Grants, awards and other acquisitions from the issuer.* Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction) shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;

(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; *provided that* such ratification occurs no later than the date of the next annual meeting of shareholders; or

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, *provided that* this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

(e) *Dispositions to the issuer*. Any transaction involving the disposition to the issuer of issuer equity securities (other than a Discretionary

> Transaction) shall be exempt, *provided that* the terms of such disposition are approved in advance in the manner prescribed by either paragraph (d)(1) or paragraph (d)(2) of this section.
>
> (f) *Discretionary Transactions*. . . .

17 C.F.R. § 240.16b-3 (emphasis added).

National and Sterling argue that Rule 16b-3(d), which exempts "[g]rants, awards, and other acquisitions from the issuer," exempts the reclassification transaction. In particular, they contend that the conversion of their preferred stock holdings into common stock constitutes a transaction that (1) was approved by the issuer's (Fairchild's) board of directors; and (2) was approved by a majority of shareholders entitled to vote, either of which circumstance suffices to trigger the rule's exemption. National Br. at 50 & n.13; Sterling Br. at 45-46. Levy disagrees with their contention as he urges that Rule 16b-3 by its terms is not applicable here.

According to Levy, the term "other acquisitions" in Rule 16b-3(d) cannot mean "any" and "all" other transactions for several reasons. First, Levy argues that the principle of *ejusdem generis* supports construing the term "other acquisitions" in Rule 16b-3's exemption of grants, awards, and "other acquisitions" as constrained within a category that includes grants and awards. Appellant's Br. at 25-27; Appellant's Reply Br. at 18-20. In other words, Rule 16b-3(d) does not, in Levy's view, apply to *all other* acquisitions, but only those that contain some element of compensation. Appellant's Br. at 26-27; Appellant's Reply

Br. at 18-26. Second, Levy asserts that the SEC's regulatory history surrounding Rule 16b-3(d) suggests that we should limit the rule to compensatory transactions. Appellant's Br. at 23-24; Appellant's Reply Br. at 21-23.

Third, Levy argues that Rule 16b-3(f) is more restrictive than the interpretation of Rule 16b-3(d) National and Sterling advance to the extent that Rule 16b-3(f), regulating "discretionary transactions" involving employee benefit plans, requires a six-month waiting period between purchases and sales.[11] Levy states that it would be irrational for the

---

11. A *discretionary transaction* is a transaction pursuant to an employee benefit plan that:

> (i) Is at the volition of a plan participant;
>
> (ii) Is not made in connection with the participant's death, disability, retirement or termination of employment;
>
> (iii) Is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code; and
>
> (iv) Results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer equity security.

17 C.F.R. § 240.16b-3(b)(1).

Rule 16b-3(f) provides:

> *Discretionary Transactions.* A Discretionary Transaction shall be exempt only if effected pursuant to

(Cont'd)

SEC to impose greater restrictions on transactions pursuant to an employee benefit plan, as such transactions provide "less opportunity for speculative abuse and serve a legitimate compensatory purpose." Appellant's Br. at 28.[12]

National and Sterling counter by pointing to the text of the SEC's 1996 release adopting Rule 16b-3. National Br. at 51-52; Sterling Br. at 48-49. As National and Sterling note, the release states that

> New Rule 16b-3 exempts from short-swing profit recovery any acquisitions and dispositions of issuer equity securities . . . between an officer or director and the issuer, subject to simplified

---

(Cont'd)

> an election made at least six months following the date of the most recent election, with respect to any plan of the issuer, that effected a Discretionary Transaction that was:
>
> > (1) An acquisition, if the transaction to be exempted would be a disposition; or
> >
> > (2) A disposition, if the transaction to be exempted would be an acquisition.

Id. § 240.16b-3(f).

12. Levy makes a fourth argument that "the rule as a whole only speaks to transactions between an issuer and an officer or director who is a natural person." Appellant's Br. at 32. This argument, however, is premised upon the argument that Rule 16b-3(d) deals with transactions involving compensation; it does not have any independent force.

> conditions. A transaction with an employee benefit plan sponsored by the issuer will be treated the same as a transaction with the issuer. However, unlike the current rule, a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element.

Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 34-37260, 35-26524, 61 Fed.Reg. 30376, 30378-79 (June 14, 1996) (footnotes omitted). Levy asserts, however, that "the mere fact that the transaction does not need . . . to have a *specifically* compensatory element does not mean that the transaction does not need to have *any* compensatory element whatsoever. . . . In fact, what *specifically* implies is that there still needs to be some compensatory element to the transaction even if it is not the primary one." Appellant's Reply Br. at 23-24 (emphasis in original).

Our review of the adopting release convinces us that Rule 16b-3 primarily is concerned with employee benefit plans. The release indicates that the new rule was adopted in part to encourage participation in employee benefit plans:

> In February 1991, in response to developments in the trading of derivative securities, the growth of complex and diverse employee benefit plans, and substantial filing delinquencies, the Commission adopted comprehensive changes to the beneficial ownership and short-swing profit recovery rules and forms applicable to insiders pursuant to

> section 16. While many aspects of the new section 16 rules were favorably received, unanticipated practical difficulties arose in implementing the new rules, particularly with respect to thrift and similar employee benefit plans. In particular, issuers and insiders stated that the application of current Rule 16b-3 to these plans is cumbersome, presents significant record-keeping problems and discourages insiders from participation in plan funds holding employer securities.

Ownership Reports and Trading, 61 Fed. Reg. at 30376 (footnotes omitted). The adopting release further explained that the 1995 proposals being adopted, which included the proposed new Rule 16b-3, were related to compensation:

> The 1995 proposals presented a simplified, flexible approach based on the premise that transactions between an issuer and its officers and directors are intended to provide a benefit or other form of compensation to reward service or to incentivize performance. Generally, these transactions do not appear to present the same opportunities for insider profit on the basis of non-public information as do market transactions by officers and directors. Typically, where the issuer, rather than the trading markets, is on the other side of an officer or director's transaction in the issuer's equity securities, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute. Based on its

> experience with the Section 16 rules, the Commission is persuaded that transactions between the issuer and its officers and directors that are pursuant to plans meeting the administrative requirements and non-discrimination standards of the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 ("ERISA"), or that satisfy other objective gate-keeping conditions, are not vehicles for the speculative abuse that section 16(b) was designed to prevent. Accordingly, these transactions are exempted by new Rule 16b-3 as adopted.

Id. at 30377 (footnotes omitted).[13] The release explained specifically the impetus behind new Rule 16b-3(d):

> Plans that authorize 'grant and award' transactions provide issuer equity securities to participants on a basis that does not require either the contribution of assets or the exercise of investment discretion by the participants. For example, awards of bonus stock pursuant to a salary-based formula and grants of options or restricted stock are grant and award transactions. In contrast, a 'participant-directed transaction' requires the participant to exercise investment discretion as to either the

---

13. National argues that the sentence in the above-quoted language beginning with "Typically . . ." supports a broad reading of the term "other acquisitions" in Rule 16b-3. *See* National Br. at 50. Levy argues that "[t]his quote is . . . taken entirely out of context." Appellant's Reply Br. at 24. Whether true or not, in any event, it is clear that the surrounding language is concerned with compensation.

> timing of the transaction or the assets into which the investment is made. For example, the exercise of an option and a participant's election pursuant to a thrift plan to invest either the employee or the employer contribution in issuer equity securities are participant-directed transactions.
>
> Both the current and the new rules provide a specific exemption for the grant or award of issuer equity securities. The new rule makes the exemption more readily available, since only one of three alternative conditions need be satisfied.

Id. at 30380. The release further explained that, whereas the 1995 proposal referred only to "grants" and "awards," the term "other acquisitions" was added to account for the participant-directed transactions mentioned above.

> Commenters responded favorably to this proposal. They expressed concern, however, that some participant-directed transactions (such as deferrals of bonuses into phantom stock and other deferred compensation programs) that are exempt under the current rule would lack an exemption under the new rule.
>
> The 1995 proposal was intended to permit such transactions, which ordinarily do not present opportunities for abuse, an opportunity for exemption.
>
> Accordingly, as adopted, the proposed grant and award exemption has been retitled 'Grants,

Appendix A

> Awards and Other Acquisitions from the Issuer' to make it clear that participant-directed acquisitions that are not pursuant to tax-conditioned plans may rely on this exemption. . . .

Id. (footnotes omitted).[14] This statement, as well as the others previously cited, in the SEC's adopting release strongly suggest that the SEC intended, in Rule 16b-3(d), to exempt "grants, awards, and other acquisitions" with some compensatory nexus and thus the rule is inapplicable here.

We acknowledge that the statement that "a transaction need not . . . to be exempt . . . specifically have a compensatory element," 61 Fed. Reg. at 30379, appears to cut against our position. This statement, however, can be read to mean that the form of a transaction is not what matters. Rather, the weight of the SEC's pronouncements on Rule 16b-3, and particularly Rule 16b-3(d), suggest that the transaction should have some connection to a compensation-related function.

---

14. Sterling argues that the cited language of the release "does not, however, suggest that 'participant-directed' acquisitions, together with grant and award transactions, are the *only* types of transactions eligible for exemption under Rule 16b-3(d)." Sterling Br. at 49 (emphasis in original). Instead, Sterling points to another part of the release, *see id.*, which states that "[o]ther acquisitions by an officer or director from the issuer, including grants, awards and participant-directed transactions, will be exempt upon satisfaction of any one of three alternative conditions." 61 Fed. Reg. at 30377. Sterling argues that the transactions encompassed by Rule 16b-3(d) include, but are not limited to, grants, awards, and participant-directed transactions, and that *any* transaction meeting one of the required conditions should be exempt. Sterling Br. at 49-50.

The result we reach is sensible. We think that adopting National's and Sterling's view would result in any transaction between the issuer company and an officer or director that meets the remaining requirements of Rule 16b-3(d)—approval of the transaction by the board of directors or a majority of shareholders, or holding of the securities by the officer or director for more than six months[15] — being immunized from section 16(b) liability. The potential for self-dealing could be great: in a closely held corporation, directors or a majority of shareholders could arrange for the acquisition of stock in advance of an IPO, and turn around and sell shares shortly after the IPO. Because of their insider status, there would be a concern about speculative abuse injurious to other market participants.

Gryl ex rel. Shire Pharms. Group PLC v. Shire Pharms. Group PLC, 298 F.3d 136 (2d Cir. 2002), is not to the contrary. In *Gryl,* the Court of Appeals for the Second Circuit held that Rule 16b-3(d) exempted from section 16(b) transactions involving the grant of stock options to insider-directors of an issuer company, Roberts, and the subsequent conversion of those options to options in Shire, the company with which Roberts merged, pursuant to a merger plan. *See Gryl,* 298 F.3d at 139, 146. These stock options, however, had a compensatory nexus.[16]

---

15. This list is a paraphrase of the alternative conditions for exemption in Rule 16b-3(d).

16. Levy makes an alternative argument that if National's and Sterling's interpretation of Rule 16b-3(d) is correct the SEC exceeded its authority in enacting the rule. In view of our result we do not consider this point.

Appendix A

IV. CONCLUSION

In view of the foregoing, we hold that the district court erred in granting the motion of National and Sterling to dismiss Levy's complaint for failure to state a claim on which relief can be granted. We disagree with the district court's holding that Rule 16b-7 exempted the reclassification transaction as a matter of law and we do not conclude at this time that the reclassification transaction is outside the definition of "purchase" under section 16(b). We also reject the alternative basis that National and Sterling have advanced for supporting the judgment below — Rule 16b-3(d) — as inapplicable. Thus, we will reverse the order of February 5, 2002, dismissing this action and will remand the matter to the district court for further proceedings consistent with this opinion.

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B — MEMORANDUM AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF DELAWARE DATED AND FILED FEBRUARY 5, 2002

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF DELAWARE

C.A. No. 00-994

MARK LEVY,

Plaintiff,

v.

STERLING HOLDING COMPANY, LLC, NATIONAL SEMICONDUCTOR CORPORATION and FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC,

Defendants.

MEMORANDUM AND ORDER

I. INTRODUCTION

On November 28, 2000, the plaintiff Mark Levy filed this shareholder's derivative suit on behalf of the defendant Fairchild Semiconductor after making an appropriate demand to the board. The complaint alleges that defendants National Semiconductor ("National") and Sterling Holding Company ("Sterling"), who sit on the Fairchild Board of Directors, purchased Fairchild stocks and then sold those stocks at a profit within six months after purchase. Levy alleges that

National and Sterling's conduct violated the prohibition on short swing profits due to insider trading expressed in section 16(b) of the Securities and Exchange Act of 1934. *See* 15 U.S.C. § 78p(b).

Presently before the court are National and Sterling's motions to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim. In both motions the defendants contend that neither defendant violated section 16(b) because the Fairchild stocks that Levy alleges were purchased were acquired during a recapitalization of Fairchild prior to its Initial Public Offering ("IPO"). Under the terms of the recapitalization, the preferred shares National and Sterling previously held were reclassified as common stock. National and Sterling contend that when shares are acquired as the result of a reclassification, the transaction cannot be considered a purchase for section 16(b) purposes because it is exempt under SEC Rule 16b-7. The court agrees with defendants and will, therefore, grant their motion to dismiss.[1] The court will explain the rationale for its decision below.

II. FACTS

National and Sterling are both incorporated in the State of Delaware. On March 11, 1997, Fairchild was spun off from National pursuant to an Agreement and Plan of Recapitalization ("Agreement"). Two provisions of the Agreement are critical. First, the Agreement permitted

1. The court's decision makes it unnecessary to consider defendant's additional defenses under the Securities and Exchange Act.

National and Sterling to appoint directors to Fairchild's board of directors. Fairchild's board has seven directors. Of this seven, National was permitted to select one director, Sterling was permitted to select two directors, and Sterling was permitted to designate two further independent directors. Both National and Sterling exercised this option. Sterling appointed William N. Stout, Richard M. Cashin, and Paul Shorr. National selected Brian Halla, who served as the director of Fairchild during the events in question.[2]

The second relevant provision of the 1997 Agreement permitted National and Sterling to retain or purchase stock in Fairchild. National retained 4,380,000 shares of class A common stock, 5,243,621 shares of class B common stock, and 11,667 shares of 12% series A cumulative compounding preferred stock. Sterling purchased 3,553,000 shares of class A common stock, 7,099,000 shares of class B common stock, and 53,113 shares of the preferred stock. Thus, according to a prospectus filed by Fairchild on August 4, 1999, National was the beneficial owner of 14.8% of class A common stock and 14.9% of class B common stock. The prospectus also disclosed that by 1999, Sterling was the beneficial owner of 48.0% of the class A common stock and 85.1% of the class B common stock.[3] Thus, both National and Sterling had stock ownership in Fairchild exceeding ten percent.

---

2. Halla apparently ceased his service as a director in January 2000.

3. By 1999, Sterling's number of shares had grown to 14,212,000 shares of class A common stock and 28,396,000 shares of class B common stock. D.I. 1 at ¶ 13.

Appendix B

Earlier in 1999, Fairchild decided to undergo a recapitalization in anticipation of its IPO. The recapitalization contemplated that preferred shares would be converted to common stock. Fairchild's certificate of incorporation, however, did not provide for the conversion of preferred stock into common stock. On July 1, 1999, a majority of Fairchild's common and preferred shareholders voted to convert all shares of preferred stock into class A common stock "automatically" upon completion of the IPO. The certificate of incorporation was amended to reflect the change, and also set out a formula for the conversion of the shares.[4] According to the formula, each share of preferred stock was worth 75.714571 shares of class A common stock. Thus, Sterling acquired 4,021,428 shares of common stock and National acquired 888,362 shares. The acquisition occurred on August 9, 1999, the date the IPO was completed.

On January 19, 2000, Sterling sold 11,115,000 shares of class A common stock for a profit of $58,511,777.00. National sold 7,243,360 shares of class A common stock at a profit of $14,124,958.00 on the same date. Both sales were within six months of the time National and Sterling acquired the new shares of common stock.

III. STANDARD OF REVIEW

In ruling on a motion to dismiss, the factual allegations of the complaint must be accepted as true. *See Graves v. Lowery*, 117 F.3d 723, 726 (3d Cir. 1997); *Nami v. Fauver*,

4. The formula required that each investor would receive $1,000 per share liquidated value for the preferred stock plus accumulated unpaid dividends. This number was then divided by $17.39 per share to arrive at a 75 to 1 ratio.

82 F.3d 63, 65 (3d Cir. 1996). Moreover, a court must view all reasonable inferences that may be drawn from the complaint in the light most favorable to the non-moving party. *See Jenkins v. McKeithen*, 395 U.S. 411, 421 (1969); *Schrob v. Catterson*, 948 F.2d 1402, 1405 (3d Cir. 1991). A court should dismiss a complaint "only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *See Graves*, 117 F.3d at 726; *Nami*, 82 F.3d at 65 (both citing *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)).

IV. DISCUSSION

Section 16(b) of the Securities and Exchange Act is intended to prevent "the unfair use of information . . . by beneficial owner[s], director[s], or officer [s]" in connection with "any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months." *See* 15 U.S.C. § 78(p)(b). Thus, by the language of the statute at least two elements must be present: (1) beneficial owners, directors, or officers (commonly known as insiders); and (2) a purchase or sale within six months.

The parties do not dispute that both National and Sterling are insiders. Indeed, both corporations owned over ten percent of the Fairchild shares, which qualifies them as beneficial owners. *See* 15 U.S.C. § 78(p)(a) (defining beneficial owner as one owning more than "ten percentum" of the stock at issue). Moreover, even if this were not so, both National and Sterling sent representatives to Fairchild's board of directors. Since three of these directors were not independent, they can

be considered agents of National and Sterling. Thus, National and Sterling were also directors of Fairchild. *See id.* (mentioning directors and officers). Due to their involvement as directors and beneficial owners, both companies are subject to the provisions of the Securities and Exchange Act. The court therefore, need only determine whether their actions violated the applicable securities laws.

A. Reclassifications are Exempt under the Securities Laws

Although the parties agree that National and Sterling were insiders, the parties vigorously dispute whether the transaction at issue involved a "purchase." As defendants point out, the Securities and Exchange Commission has exempted several transactions from the scope of the term "purchase." In particular, the SEC has exempted "mergers, reclassifications, and consolidations" via SEC Rule 16b-7. *See* 17 C.F.R. § 240.16b-7. As Levy points out in his brief, reclassifications are not explicitly discussed in Rule 16b-7. Nevertheless, in a 1981 Interpretive Release, the SEC was asked "Although not specifically mentioned, does Rule 16b-7 apply to . . . reclassifications?" *See* Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 18114, 23 SEC Docket 856,914 (Question 142) (Sept. 24, 1981), *available* at 1981 WL 31301. The SEC replied that the rule "can be applied to reclassifications." *See id.* In light of the SEC's own interpretation of its rules and regulations, it seems clear the provisions of Rule 16b-7 apply to reclassifications. It would seem then that reclassifications are exempt from the scope of Section 16(b).

B. The Transaction Here was a Reclassification

When presented with facts similar to those before the court, the SEC has ruled that section 16(b) was not violated. In the *Monk-Austin, Inc.*, case, SEC No- Action letter, 1992 WL 337451, Monk-Austin wrote to the SEC inquiring whether its proposed IPO would violate securities laws. Monk-Austin completed a recapitalization wherein its capital stock would be converted into a new class of common stock. *Id.* at *1. The SEC ruled that the recapitalization was exempt under Rule 16b-7. *Id.* at *8. At least one reported circuit court decision is in accord with this result. *See Roberts v. Eaton*, 212 F.2d 82, 83 (2d Cir. 1954) (rejecting argument that reclassification should be considered a purchase).

The facts here are similar to those in *Monk-Austin*. As in *Monk-Austin*, here Fairchild simply reclassified its stock from one form to another. Thus, it appears that the Fairchild transaction should also be considered a reclassification. Although Levy attempts to distinguish *Monk-Austin* by noting that in *Monk-Austin*, the shares were convertible from the inception of the corporation, the court agrees with the defendants that this fact did not appear to influence the SEC's decision.

Levy further argues that the exchange here should not be considered a reclassification because it was actually a liquidation. The court disagrees. Although the liquidated value of the stock was used to compute the conversion formula, this will not qualify the transaction as a liquidation of stock as neither National nor Sterling nor any of the other investors received any cash for their value. In *Monk-Austin*,

a similar formula was employed without objection by the SEC. *See Monk-Austin*, 1992 WL 337451, at *5 (noting that shareholders were to receive $52 per share upon liquidation and that number was incorporated into the formula for conversion of stocks). The court will, therefore, reject the argument made here.

Levy also attempts to argue that the transaction here should not be considered a reclassification because National and Fairchild actually increased their ownership interests. However, in *Monk-Austin*, the court noted that there was a "conversion ratio of 128-for-1 . . . so there is no shift of proportionate interests . . ." *See id.* at *6. In the present case, there is a conversion ratio of approximately 75-to-1. This formula is similar to the one employed in *Monk-Austin*. Although Levy asserts that this formula gave National and Sterling a larger interest in the corporation according to the formula, the interest in the corporation would remain the same because the amount of common shares issued would depend solely on the value of the preferred shares currently held. Thus, neither Sterling nor National acquired a substantially greater interest in Fairchild.

Morever, even if the corporation's interests and profits did increase, this will not be dispositive where the transaction does not change the "character of the investment or the nature of the market risk assumed." *Rothenberg v. United Brands*, 1977 WL 1014, at *6-*7 (S.D.N.Y. May 11, 1977). The critical inquiry here appears to be whether the stocks are exchanged for items with a higher intrinsic value. *Compare id.* at *2 (holding that section 16(b) not violated in converting one type of stock to another type of stock although

converted stock had "greater economic value") with *Colan v. Mesa Petroleum Co.*, 951 F.2d 1512, 1525 (9th Cir. 1991) (finding section 16(b) liability where stock was exchanged for debt securities, which had "higher market value."). In the present case, neither the character nor the risk changed because the Fairchild preferred stock was exchanged for substantially similar securities with a similar market risk involved. Thus, unlike *Colan*, Fairchild did not attempt to exchange stocks for investments—such as bonds—that present a different sort of market risk and, therefore, a possibly greater market value. Since the investment security and the associated risk remained constant before and after the conversion, the court finds no reason to hold that this transaction should not be treated as a reclassification.

On balance, the court finds that all relevant factors indicate that the transaction here was a reclassification of stock in anticipation of an IPO, rather than a purchase. The SEC has repeatedly interpreted its regulations as exempting reclassifications from the scope of section 16(b). Thus, the court concludes that in light of the facts presented, the transaction here does not subject either of the defendants to section 16(b) liability. As a result, the court finds the plaintiff has failed to state a claim for which relief can be granted, and will dismiss the complaint.

Appendix B

V. CONCLUSION

For the foregoing reasons, Levy has failed to state a claim for which relief can be granted. The court will, therefore, grant each defendants' motion to dismiss the complaint pursuant to Rule 12(b)(6).

NOW, THEREFORE, IT IS HEREBY ORDERED that:

1. The defendant Sterling's "Motion to Dismiss" (D.I.7) is GRANTED;

2. The defendant National Semiconductor's "Motion to Dismiss" (D.I.9) is GRANTED;

3. The Plaintiff's Complaint (D.I.1) is DISMISSED With Prejudice;

4. The clerk shall close this case.

Dated: February 5, 2002

s/ [illegible]
UNITED STATES DISTRICT JUDGE

APPENDIX C — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DENYING PETITION FOR REHEARING DATED APRIL 30, 2003

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 02-1698

MARK LEVY,

Appellant

v.

STERLING HOLDING COMPANY, LLC.; NATIONAL SEMICONDUCTOR CORPORATION; FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.

On Appeal from the United States District Court
for the District of Delaware
(D.C. Civ. No. 00-00994)

SUR PETITION FOR REHEARING

BEFORE: BECKER, *Chief Judge*, SLOVITER, SCIRICA, NYGAARD, ALITO, MCKEE, RENDELL, AMBRO, FUENTES, SMITH, GREENBERG, and MICHEL,*
Circuit Judges

---

* Honorable Paul R. Michel, Judge for the United States Court of Appeals for the Federal Circuit, sitting by designation.

Appendix C

The petition for rehearing filed by appellees, Sterling Holding Company, LLC and National Semiconductor Corporation, in the above captioned matter having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the court in regular active service, and a majority of the judges who concurred in the decision not having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court en banc, the petition for rehearing is denied. Judge Greenberg's and Judge Michel's votes respectively are limited to denying and granting rehearing before the original panel. Chief Judge Becker, Judge Ambro, and Judge Smith would grant rehearing before the full court. Judge Michel would grant rehearing before the original panel.

BY THE COURT:

s/ [illegible]
Circuit Judge

DATED: APR 30 2003

APPENDIX D — STATUTES AND REGULATIONS INVOLVED

15 U.S.C. § 78p

* * *

(b) Profits from purchase and sale of security within six months

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by

the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

* * * *

Appendix D

17 C.F.R. § 240.16b-3

§ 240.16b-3 Transactions between an issuer and its officers or directors.

(a) *General.* A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.

* * *

(d) *Grants, awards and other acquisitions from the issuer.* Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction) shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;

(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to

vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; *provided that* such ratification occurs no later than the date of the next annual meeting of shareholders; or

(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, *provided that* this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

* * *

Appendix D

17 C.F.R. § 240.16b-7

§ 240.16b-7 Mergers, reclassifications, and consolidations.

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger or consolidation, in exchange for a security of a company which, prior to the merger or consolidation, owned 85 percent or more of either

(i) The equity securities of all other companies involved in the merger or consolidation, or in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies involved in the merger or consolidation, computed according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation, or such shorter time as the company has been in existence.

(2) The disposition of a security, pursuant to a merger or consolidation, of a company which, prior to the merger or consolidation, owned 85 percent or more of either

(i) The equity securities of all other companies involved in the merger or consolidation or, in the case of a consolidation, the resulting company; or

(ii) The combined assets of all the companies undergoing merger or consolidation, computed according to their book values prior to the merger or consolidation as determined by reference to their most recent available financial statements for a 12 month period prior to the merger or consolidation.

(b) A merger within the meaning of this section shall include the sale or purchase of substantially all the assets of one company by another in exchange for equity securities which are then distributed to the security holders of the company that sold its assets.

(c) Notwithstanding the foregoing, if a person subject to section 16 of the Act makes any non-exempt purchase of a security in any company

involved in the merger or consolidation and any non-exempt sale of a security in any company involved in the merger or consolidation within any period of less than six months during which the merger or consolidation took place, the exemption provided by this Rule shall be unavailable to the extent of such purchase and sale.

APPENDIX E — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DATED MARCH 31, 2003

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 02-1698

MARK LEVY,

Appellant

v.

STERLING HOLDING COMPANY, LLC.; NATIONAL SEMICONDUCTOR CORPORATION; FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.

On Appeal from the United States District Court
for the District of Delaware
(D.C. Civ. No. 00-00994)

Before: BECKER, *Chief Judge*, SLOVITER, SCIRICA, NYGAARD, ALITO, MCKEE, RENDELL, FUENTES, SMITH, GREENBERG, and MICHEL,* *Circuit Judges*

ORDER

The motion of the Securities and Exchange Commission to file an amicus curiae brief is granted and the brief received

---

* Honorable Paul R. Michel, United States Circuit Judge for the Federal Circuit, sitting by designation.

by the Clerk of this court on February 28, 2003, is accepted as that brief. The appellant may serve and file an answering brief to the SEC brief within ten days.

BY THE COURT,
s/ [illegible]
Circuit Judge

DATED: MAR 31 2003

APPENDIX F — MOTION FOR LEAVE TO FILE MEMORANDUM, AND MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, IN SUPPORT OF APPELLEES' PETITION FOR REHEARING AND REHEARING *EN BANC* DATED FEBRUARY 27, 2003

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 02-1698

MARK LEVY,

Plaintiff-Appellant,

v.

STERLING HOLDING COMPANY, LLC., NATIONAL SEMICONDUCTOR CORPORATION, and FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.,

Defendants-Appellees.

On Appeal from the United States District Court
for the District of Delaware

MOTION OF THE SECURITIES AND EXCHANGE COMMISSION FOR LEAVE TO FILE A MEMORANDUM, *AMICUS CURIAE*, IN SUPPORT OF APPELLEES' PETITION FOR REHEARING OR REHEARING *EN BANC*

The Securities and Exchange Commission, the agency responsible for the administration and enforcement of the federal securities laws, respectfully requests leave from this Court to file the accompanying memorandum *amicus curiae* in support

of appellees' petition for rehearing or rehearing *en banc*. In support of this motion, the Commission states as follows:

1. This is a derivative action seeking to recover "short swing" profits realized in securities transactions by certain insiders of Sterling Holding Co., LLC., pursuant to Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b). The defendants argue that the transactions are exempt from Section 16(b) under two Commission Rules, Rule 16b-3(d), 17 C.F.R. 240.16b3(d), and Rule 16b-7, 17 C.F.R. 240.16b-7. On December 19, 2002, a panel of this Court held that the transactions were not exempt under the rules.

2. The Commission has a strong and obvious interest in this case. Although Section 16(b) is enforced in private actions only, and not by Commission enforcement actions, it provides that the Commission may exempt from Section 16(b) "any transaction * * * as not comprehended within the purpose" of the statute. In holding that the transactions here were not exempt under the rules, the Court viewed the rules as ambiguous and therefore applied its view of how the Commission would apply the rules to these transactions. As discussed in the accompanying memorandum, the panel misconstrued the Commission's intent, and thereby frustrated its purpose, in adopting the rules.

3. We believe that it is important that, in considering whether to rehear this matter, the Court be aware of the Commission's views. This Court has recognized that "[a]n agency's interpretation of its own regulations is 'controlling * * * unless it is plainly erroneous or inconsistent with the regulation.'" *Chong v. INS*, 264 F.3d 378, 389 (3d Cir. 2001) (*quoting Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410

(1945)). The Second Circuit has held, in a prior Section 16(b) case, that courts are "bound by the SEC's interpretations of its regulations in its *amicus curiae* briefs, unless they are 'plainly erroneous or inconsistent with the regulation[s].'" *Levy v. Southbrook International Investments, Ltd.*, 263 F.3d 10, 15 (2d Cir. 2001), *cert. denied*, 122 S.Ct. 1911 (2002) (quoting *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 128 (2d Cir. 2000)) (in turn quoting *Auer v. Robbins*, 519 U.S. 452, 461-63 (1997)).

For the foregoing reasons, the Commission respectfully requests leave to file the accompanying memorandum *amicus curiae* in support of the defendants' petition for rehearing. The Commission further requests that, should the Court grant rehearing, the Commission be granted permission to file a brief explaining its position in full.

Respectfully submitted,

s/ Eric Summergrad
ERIC SUMMERGRAD
Deputy Solicitor

s/ Allan A. Capute
ALLAN A. CAPUTE
Special Counsel to the Solicitor

Securities and Exchange Commission
Washington, D.C. 20549-0606
(202) 942-0837 (Capute)

Dated: February 27, 2003

Appendix F

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 02-1698

MARK LEVY,

Plaintiff-Appellant,

v.

STERLING HOLDING COMPANY, LLC., NATIONAL SEMICONDUCTOR CORPORATION, and FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.,

Defendants-Appellees.

On Appeal from the United States District Court
for the District of Delaware

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, IN SUPPORT OF APPELLEES' PETITION FOR REHEARING OR REHEARING *EN BANC*

* * *

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission submits this memorandum as *amicus curiae* to urge the Court to grant the defendants' petition for rehearing or rehearing *en banc*.

Appendix F

The issue in this case is whether certain securities transactions engaged in by the defendants were exempt under Commission rules from the "short-swing" profit recovery provision in Section 16(b) of the Securities Exchange Act of 1934,15 U.S.C. 78p(b). The panel held that the transactions were not exempt under either Commission Rule 16b-3(d), 17 C.F.R. 240.16b-3(d) or Rule 16b-7,17 C.F.R 240.16b7.

The Commission's interest in this case is obvious. Although Section 16(b) is enforced in private actions only, and not by Commission enforcement actions, it provides that the Commission may exempt from Section 16(b) "any transaction *** as not comprehended within the purpose" of the statute. The panel misconstrued the Commission's intent, and has frustrated the Commission's purpose, in adopting the rules.

We believe it is important that, in considering whether to rehear this matter, the Court be aware of the Commission's views. This Court has recognized that "[a]n agency's interpretation of its own regulations is 'controlling * * * unless it is plainly erroneous or inconsistent with the regulation.'" *Chong v. INS*, 264 F.3d 378, 389 (3d Cir. 2001) (quoting *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945)). The Second Circuit has held, in a prior Section 16(b) case, that courts are "bound by the SEC's interpretations of its regulations in its *amicus curiae* briefs, unless they are 'plainly erroneous or inconsistent with the regulation[s].'" *Levy v. Southbrook International Investments, Ltd.*, 263 F.3d 10, 15 (2d Cir. 2001), *cert. denied*, 122 S.Ct. 1191 (2002) (quoting *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 128 (2d Cir. 2000)) (in turn quoting *Auer v. Robbins*, 519 U.S. 452, 461-63 (1997)).

Appendix F

STATEMENT OF THE CASE

This is a derivative action by Mark Levy, a shareholder in Fairchild Semiconductor ("Fairchild"), seeking to recover, under Section 16(b) of the Exchange Act, short-swing profits realized by insiders of Fairchild. The complaint alleges that defendants Sterling Holding Company ("Sterling") and National Semiconductor ("National"), purchased Fairchild stock and then sold it at a profit within six months. The purchase occurred when Sterling and National each had preferred Fairchild stock that they owned converted by the issuer into common stock. Since both companies were holders of more than 10% of the stock, and had officers who sat on Fairchild's board of directors, it is not disputed that' they were insiders whose transactions were subject to Section 16(b).

A majority of the shareholders voted by written consent to amend Fairchild's certificate of incorporation in order to provide for a plan of recapitalization in which all of Fairchild's preferred stock was converted into class A common stock at the time Fairchild made an initial public offering of the common stock ("IPO"). The IPO took place on August 9, 1999, resulting in the acquisition on that date by Sterling and National of Fairchild common stock. Less than six months later, on January 19, 2000, Sterling and National sold substantial amounts of common stock, realizing a profit of $58.5 million for Sterling and $14.1 million for National.

Appendix F

Defendants moved to dismiss the complaint, arguing that the conversion was exempt from Section 16(b) liability under Commission Rules 16b-3(d) and 16b-7. The district court agreed that the transaction involved a reclassification of Fairchild's stock exempted by Rule 16b-7, but did not reach the issue whether Rule 16b-3(d) applied. *Levy v. Sterling, Holding Company, LLC.*, Fed Sec L. Rep. (CCH) ¶ 91,689, 2002 WL 187513 (D. Del. Feb. 5, 2002). Levy appealed and, on December 19, 2002, a panel of this Court reversed the district court. *See Levy v. Sterling Holding Company, LLC.*, 314 F.3d 106 (3d Cir. 2002), holding that neither of the exemptions applied to this transaction.

DISCUSSION

I. IN HOLDING THAT FAIRCHILD'S RECLASSIFICATION IS NOT EXEMPT UNDER RULE 16b-3(d), THE PANEL IMPOSED A REQUIREMENT THAT IS NOT, AND WAS NOT INTENDED BY THE COMMISSION TO BE, PART OF THE RULE.

The panel incorrectly held that the acquisitions of common stock were not, as a matter of law, exempt from Section 16(b) liability by Rule 16b-3(d). Rule 16b-3 exempts from Section 16(b) certain transactions between issuers of securities and their officers and directors. Rule 16b-3(a) provides that any "transaction between the issuer * * * and an officer or director of the issuer that involves equity securities shall be exempt from section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section." As this makes clear, the only limitations on the exemption for transactions between the issuer and its

officer or director are those objective conditions set forth in the later subsections of the rule, each of which applies to different categories of transactions.

Of relevance here is subsection (d) of the rule. Rule 16b-3(d) is entitled "Grants, awards and other acquisitions from the issuer." It exempts from Section 16(b) liability "[a]ny transaction involving a grant, award or other acquisition from the issuer" if any one of three conditions is met.[1] Of relevance here, the exemption applies if "[t]he transaction is approved * * * by * * * the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting * * *; or the written consent of the holders of a majority of the securities of the issuer * * *." The plaintiff concedes, and the panel did not dispute, that the reclassification here was approved by the written consent of the owners of the majority of Fairchild's securities (Levy Br. p.5. *See also* Complaint, A-24 at ¶ 20.)

The panel, however, held that Rule 16b-3(d) does not apply where the stock is not conferred on the insider for a compensatory purpose. This condition does not appear in the rule. The panel apparently accepted the plaintiff's argument that when Rule 16b-3(d) limits its coverage to transactions involving "grants, awards, or other acquisitions," it is speaking only of transactions that have some compensation-related aspect. The plaintiffs argued that "grants" and "awards" are compensation-related, and that under the principle of *ejusdem generis*, "other acquisitions" must be as well. Here, the panel concluded, there was no such relation. *See* 314 F.3d 121-22.

1. The provision does not apply to "Discretionary Transactions," as defined in Rule 16b-3, a category not relevant here.

The problem with this analysis is that it runs directly contrary to the Commission's stated reasons for adopting the exemption. This Court has made clear that the principle of *ejusdem generis* is a tool of statutory construction, and "'should not be employed when the intention of the [agency] is otherwise evident.'" *Waterfront Commission of New York Harbor v. Elizabeth-Newark Shipping Inc.*, 164 F.3d 177, 184 (3d Cir. 1998) (*quoting United States v. Frumento*, 563 F.2d 1083, 1090 (3d Cir. 1977)). The panel found no clear statement of the Commission's intent, and concluded that had the Commission considered the matter, it would limit the exemption to compensation-related transactions. 314 F.3d at 124. That is an incorrect reading of the Commission's intent.

Prior to 1996, Rule 16b-3 exempted only transactions pursuant to employee benefit plans. It is true, as the panel noted, that a significant motivating purpose behind the 1996 amendments was to promote employee benefit plans and other compensatory arrangements. But that does not mean that the Commission sought to promote that purpose through a rule that is limited to such plans and arrangements. The purpose of a statute or rule does not necessarily define its intended scope.

It was not the compensatory nature of the transactions that made them suitable for exemption from Section 16(b). "Typically," the Commission explained when it adopted the rule, "where the issuer, rather than the trading markets, is on the other side of an officer or director's transaction in the issuer's equity securities, any profit obtained is not at the expense of uniformed shareholders and other market

participants of the type contemplated by the statute." *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Exchange Act Release No. 37260, 61 Fed. Reg. 30376, 30377 (June 14, 1996). "Based on its experience with the Section 16 rules," the Commission continued, "transactions between the issuer and its officers and directors that are pursuant to plans meeting the administrative requirements, * * * or that satisfy other objective gate-keeping conditions, are not vehicles for the speculative abuse that Section 16(b) was designed to prevent." *Id.* The Commission viewed Section 16(b) liability as unnecessary in these transactions because they involve transactions with the issuer and because they are subject to "objective gate-keeping" conditions. Among those gate-keeping conditions were approval by the issuer's board or shareholders.

The Commission viewed satisfaction of one of these gate-keeping conditions, not the compensatory nature of the transaction, as providing the necessary protection to justify exemption under Rule 16b-3(d). Accordingly, the Commission stated that under the new rule "unlike the current rule, a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element." *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Exchange Act Release No. 37260, 61 Fed. Reg. at 30379. Although the panel quoted this language, it seized on the use of the word "specifically" as implying that the grant, award, or other acquisition nevertheless must have some relation to compensation. That, however, was not the Commission's intention, and it

is a reading that runs counter to the Commission's explanation of the rationale for the rule. The Commission did not rely on the compensatory nature of the transaction in determining when the exemption should be available under Rule 16b-3(d).

In holding that the transactions must be compensation-related, the panel also quoted language from the release suggesting that the Commission adopted the term "other acquisitions" in response to "concern * * * that some participant-directed transactions (such as deferrals of bonuses to phantom stock and other deferred compensation programs) that are exempt under the current rule would lack an exemption under the new rule." 314 F.3d at 123-24 (quoting 61 Fed. Reg. at 30380). The Commission explained that the term "other acquisitions" was added "to make it clear that participant-directed acquisitions that are not pursuant to tax-conditioned plans may rely on this exemption [Rule 16b-3(d)]" so long as they are not "Discretionary Transactions," which are subject to Rule 16b-3(f). *Id.* at 124.

Elsewhere in the release, however, a Commission stated that "[o]ther acquisitions by an officer or director from an issuer, including grants, awards and participant-directed transactions, will be exempt upon the satisfaction of any one of the three alternative conditions . . . [of Rule 16b-3(d)]." 61 Fed. Reg. at 30377. This statement shows that the Commission did not view "other acquisitions" as limited to participant-directed plans; it viewed the term only as "including" such plans.

Although the panel voiced policy reasons for its decision, reasons urged by the plaintiff as well, they are not policy reasons evidenced in the rule or the Commission's releases. The panel's decision countermands the Commission's intention to make application of Rule 16b-3 simpler. Participants in these transactions, who prior to this decision could clearly ascertain if the transaction satisfied one of the objective Rule 16b-3(d) "gate-keeping" conditions, and accordingly was exempt, will be left uncertain as to whether a court would subjectively view the transaction as sufficiently and legitimately compensation-related.

II. THE PANEL MISCONSTRUED RULE 16b-7 AS NOT APPLYING TO RECLASSIFICATIONS INVOLVING ANY CHANGE AT ALL IN THE INSIDER'S INTEREST IN THE ISSUER.

The insiders' transactions are exempt from Section 16(b) by virtue of Rule 16b-7, which exempts certain "mergers, consolidations, and reclassifications." In holding otherwise, the panel incorrectly held that the rule does not apply to reclassifications that either result in insiders increasing their proportional ownership of common stock or alter the risks and benefits of the insider's investment. 314 F.3d at 117. Here too, the panel went beyond the terms of the rule and the Commission's intent in adopting the rule.

In imposing this requirement, the panel assured that few reclassifications will be exempt under Rule 16b-7, since almost all reclassifications have at least one, and usually both, of the characteristics that the court found disqualifying. Indeed, if the original security and the security for which it

is being exchanged were precisely the same, there typically would be little need for a reclassification at all.

The issue whether reclassifications are exempt from Section 16(b) was the subject of early litigation. Even before there was an applicable rule, the courts dealt with the issue by examining, on a case-by-case basis, whether the reclassification posed a risk of insider abuse. These cases often involved the drawing of fine distinctions, turning on such matters as whether the insiders' proportional investment in the company changed, whether the reclassification occurred at the insiders' initiative or on a class-wide basis, and what sort of disclosure had been made to other shareholders. In many cases, reclassifications were deemed to be "unorthodox" transactions not subject to Section 16(b). See *Roberts v. Eaton*, 212 F.2d 82 (2d Cir. 1954); *Hayes v. Simpson*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,693, 1980 WL 1460 (S.D.N.Y. Nov. 18, 1980); *Rothenberg v. United Brands Co.*, [1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,045, 1977 WL 1014 (S.D.N.Y. May 11, 1977). *See also Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966). *See also Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 n.24 (1973) ("The term ['unorthodox transaction'], has been applied to stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights, and warrants.").

This approach changed following the adoption of Rule 16b-7. Although as originally adopted in 1952, the rule only applied to "mergers" and "consolidations," *see Notice of Proposal to Adopt a Rule Exempting from the Operation of*

Appendix F

Section 16(b) Certain Acquisitions and Dispositions of Securities Pursuant to Merger and Consolidations, Exchange Act Release No. 4696, 1952 SEC LEXIS 63 (Apr. 1952), the Commission staff construed it as also applying to reclassifications. In a 1981 interpretive release, the staff stated that "Rule 16b-7 does not require that the security received in exchange be similar to that surrendered, and the rule can apply to transactions involving reclassifications." *Interpretive Release on Rules Applicable to Insider Reporting and Trading*, Exchange Act Release No. 18114, 1981 WL 31301, at *57 (Sept. 24, 1981). In 1991, the Commission amended the title of Rule 16b-7 to include "reclassifications." *See Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Exchange Act Release No. 28869, 56 Fed. Reg. 7242, 7272 (Feb. 21, 1991). The adopting release indicates that the change was not intended to effect any "substantive" changes to the rule, and reaffirmed the staff's 1981 view that the rule applies to reclassifications. *Id.* at 7262-63. Moreover, the Commission recently expressly described reclassifications as among the transactions exempted by Rule 16b-7. *See Form 8-K Disclosure of Certain Management Transactions*, Exchange Act Release No. 45742, 67 Fed. Reg. 19914,19919 & n.56 (Apr. 23, 2002) (proposing release).

Although the rule does not contain specific standards for reclassifications, the standards for mergers and consolidations have been applied to reclassifications. In general terms, the rule provides that the acquisition of a security pursuant to a merger or consolidation is not subject to Section 16(b) if the security being relinquished is in a company that, prior to the merger or consolidation, owned

85% of either the stock or assets of all of the other companies party to the merger and consolidation. In relevant respects a reclassification is little different from a merger exempted by Rule 16b-7. In both cases, all stock in a class is exchanged on terms that have been approved by the board and/or shareholders. The exchange occurs on a class-wide basis. In the case of a merger subject to the rule, the combining companies were already 85% cross-owned, so that the combination effects no major change in the acquiring company's business. In a reclassification, the issuing company remains identical—there is no change in the business. Indeed, the similarities between the two can be readily seen by the fact that a reclassification could also be effected by the issuer creating a new shell company, capitalizing it, merging the old company into the new, and then exchanging stock in the old company for stock in the new.

Thus, it would be inappropriate to impose upon reclassifications conditions that would not apply to mergers. Yet this is precisely what the panel did here. Although the panel recognized that the rule may exempt reclassifications, it held that here, where the insiders increased their common stock holdings and exchanged preferred stock for common stock with different rights and risks, the exemption was not available. This analysis misapplies and misconstrues the rule.

First, the panel held that because the insiders' percentage of common stock increased—Sterling's proportionate interest in the Fairchild Common Stock increased from 48.03% to 52.18% and National Semiconductor's increased from 14.80% to 15.08%—Rule 16b-7 would not apply. Even if it were

true that the insiders' overall investment in the company had increased, we do not believe that would make Rule 16b-7 unavailable. The rule by its terms exempts acquisitions that satisfy either 85% cross-ownership test. Where a merger involves a parent company buying out the remaining 15% of the other company's stock, the percentage ownership of the prior owners in the merged entity is going to change. Yet that fact does not mean the rule is unavailable.

In any event, in this case the insiders' investment in the company did not change. Their common stock position increased only to the extent the reclassification converted preferred stock into common stock. As a result of the transaction, their preferred stock interest declined to zero because the recapitalization extinguished that entire class. As the district court noted, and the panel did not dispute, these transactions presumably involved exchanges of financial interests of equivalent value. *Levy v. Sterling Holding Company, LLC.*, 2002 WL 187513, at *4. The percentage of common stock increased, but a financially equivalent amount of preferred stock was given up. Overall, the value of the insiders' investment in the company did not substantially change, if at all.

The only difference between the two interests, therefore, is that previously the insiders owned preferred stock, while after the reclassification they owned common stock. The panel viewed these securities as having substantially different risk characteristics because one enjoyed a fixed dividend and the other did not. The panel reasoned that this change was sufficient to remove the transaction from the exemptive scope of Rule 16b-7. The panel also appears to

have based this conclusion at least in part on the fact that before the reclassification the preferred stock was not convertible into common stock. We do not believe that the language of Rule 16b-7 supports these distinctions.

If these were relevant distinctions for reclassifications, however, it would also be true for mergers and consolidations. A merger, after all, involves the exchange of securities of one company for those of another, and the exchange could readily involve a swap of preferred stock for common stock. Yet nothing in the rule excludes such a transaction from exemption under the rule. Indeed, as noted, the issuer here could have come within the literal terms of the rule simply by creating a 100% owned subsidiary, merging itself into the subsidiary, and giving the insiders common stock in the new company in exchange for their preferred. To interpret Rule 16b-7 to require the securities received to have the same risk characteristics as those exchanged is contrary to the language of the rule and introduces elements of subjectivity that would make it difficult to plan transactions in reliance on the exemption.

There is no reason to believe that an exchange of one form of equity for another financially equivalent form of equity should make the Rule 16b-7 exemption unavailable. Even under the old "unorthodox" transaction cases, a reclassification could be held judicially exempt from Section 16(b) even where preferred stock was exchanged for common stock. *See Roberts v. Eaton*, 212 F.2d at 82 (reclassification of common stock into preferred stock held not subject to Section 16(b)).

Appendix F

CONCLUSION

For the foregoing reasons, the appellees' petition for rehearing or rehearing *en banc* should be granted. The Commission further requests that if the Court grants rehearing, it be allowed to file a brief more fully explaining its position to the Court.

Respectfully submitted,

s/ Meyer Eisenberg
MEYER EISENBERG
Deputy General Counsel

s/ Eric Summergrad
ERIC SUMMERGRAD
Deputy Solicitor

s/ Allan A. Capute
ALLAN A. CAPUTE
Special Counsel to the Solicitor

Securities and Exchange Commission
Washington, D.C. 20549-0606
(202) 942-0837 (Capute)

Dated: February 27, 2003

APPENDIX G — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DATED MARCH 17, 2003

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 02-1698

MARK LEVY,

Plaintiff-Appellant,

STERLING HOLDING COMPANY, LLC., NATIONAL SEMICONDUCTOR CORPORATION, and FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.,

Defendants-Appellees.

On Appeal from the United States District Court
for the District of Delaware

SUPPLEMENTAL MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION IN SUPPORT OF ITS MOTION FOR LEAVE TO FILE A MEMORANDUM, *AMICUS CURIAE*, IN SUPPORT OF APPELLEES' PETITION FOR REHEARING OR REHEARING *EN BANC*

The Securities and Exchange Commission hereby files this supplemental memorandum in support of its motion for leave to file a memorandum *amicus curiae* in support of

the defendants' petition for rehearing or rehearing *en banc*. This supplement is filed pursuant to the Court's order of March 14, 2003, which directed the Commission to address "when it became aware of the litigation" in this case.

The representation of the Commission as *amicus curiae* is entrusted to the Commission's General Counsel (or, in his absence or recusal, to the official in his office acting in his stead). *See*, 17 C.F.R. 200.21. Upon becoming aware of a case in which *amicus* participation might be warranted — whether through a request of a party, a request of a court, or otherwise — the staff of the Office of the General Counsel reviews the case, consults if necessary with any affected Commission Division or Office, and determines whether to recommend *amicus* participation to the Commission. If the staff recommends participation, the Commission votes on whether to authorize it.

In this case, it is our understanding that the defendants' counsel contacted an Associate Director of the Commission's Division of Corporation Finance in late December 2002 (referred by the Division's Director) and again in the first week of January 2003, to discuss the possibility of *amicus* participation by the Commission in support of rehearing. Counsel was advised to submit a letter to the General Counsel requesting participation.

Such a letter was sent to the General Counsel on January 9, 2003. The letter was received by the subordinate staff of the Office of the General Counsel on or about January 13,

2003. The General Counsel staff has no recollection of any prior awareness of this litigation.[1]

After receiving the January 9 letter requesting *amicus* participation, the staff of the Office of the General Counsel consulted with the Division of Corporation Finance. On January 27, 2003, the Deputy General Counsel sent a letter to the Court informing it that "[t]he Commission's staff recently learned about the decision" in this case, that it was considering whether to recommend to the Commission that it participate as *amicus curiae* in connection with a planned rehearing petition, and that if the Commission authorized an *amicus* memorandum, it would seek to submit it by February 28, 2003. The proposed *amicus* memorandum was submitted to the Court on February 28, 2003.[2]

None of this is to suggest that other members of the Commission's staff might not have had some knowledge of the case prior to late December 2002. The Commission's staff

---

1. In his opposition to our motion for leave to file, the plaintiff suggests that we routinely monitor appellate litigation and thus must have known of the case earlier on. In fact, although we often learn of pending litigation on an *ad hoc* basis, we do not have a system for routine monitoring. While the Appellate Group staff also does take note of appellate decisions under the federal securities laws, we have no recollection that the Court's decision was noticed by any staff member before mid-January 2003. If it was, it was in passing only.

2. As far as we know, the Commission itself (that is, the five members of the Commission) had no knowledge of this case until a staff recommendation was made to it concerning *amicus curiae* participation in late February 2003.

engages in many activities beyond *amicus* litigation and, in the course of those activities, reviews many documents that may make mention of ongoing cases. That this may occur, however, hardly constitutes awareness by the Commission of the decision in any way, or even awareness of this litigation in the sense we have used it here — as a possible venue for *amicus* participation.[3]

It is, we believe, important to make one other point about this matter. Had the General Counsel staff been aware of this litigation prior to this Court's decision, the circumstances at that time were not such that would have warranted recommending that the Commission participate as *amicus curiae*. The staff would not have recommended participation, absent a request from the court, when the matter was pending before the district court. Absent such a request from a court, the Commission ordinarily does not participate as *amicus curiae* in district court litigation that is likely to be appealed. Had the Commission staff been aware of this matter following the district court decision, but while it was first pending before the Court, it also would not have recommended, absent a request from the Court, that the Commission participate as

3. For example, passing reference to the district court litigation was made in a footnote in a March 30, 2001 letter sent to the then Director of the Division of Corporation Finance by an American Bar Association committee, and reviewed by Division staff. In footnote 71 on page 26 of a 31 page letter the Committee noted that the plaintiff in this case was arguing that Rule 16b-7 does not apply to any reclassifications, a position rejected by the panel. *See* 314 F.3d at 114 ("the rule must encompass some reclassifications."). The ABA Committee reference took place before there was any court decision in this case.

amicus curiae. The Commission does not routinely participate as *amicus curiae* in where a district court has ruled correctly and the prospect of reversal on appeal appears to be low. The district court's decision in this case is fully consonant with the Commission's position in this case, and the staff would not have anticipated that the Court would rule otherwise. It was only after the panel issued what we believe to be a seriously incorrect decision concerning Commission rules that the need for Commission participation in this matter became apparent.

Respectfully submitted,

s/ Eric Summergrad
ERIC SUMMERGRAD
Deputy Solicitor

s/ Allan A. Capute
ALLAN A. CAPUTE
Special Counsel to the Solicitor

Securities and Exchange Commission
Washington, D.C. 20549-0606
(202) 942-0837 (Capute)

Dated: March 17, 2003